

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.wickenslaw.com — click Dental Law.



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Partnerships — Three Ways To Do It / Seven Problems To Deal With

Part I – The Associate Buy-In

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PARTNERSHIPS – THREE WAYS TO DO IT:
SEVEN PROBLEMS TO DEAL WITH

PART I – THE ASSOCIATE BUY-IN

While I personally think that the most effective way to practice dentistry and its specialties is as a sole practitioner, partnerships or practices consisting of two or more owners are becoming more common as a practice exit and entry option¹ due to the number of practices that grow then expand or relocate. As such, the purpose of this article is to inform the reader, be it the doctor, non-doctor spouse or advisor(s), of the benefits and little known but very important tax risks under each of the basic three business and tax structures of partnership.^{2, 3} Due to the length of this article, it is divided into two parts; the associate buy-in and the owner buy-out.

The first business and tax structure is the purchase and sale of stock in a professional corporation in after-tax dollars. The second is the purchase and sale of stock in a professional corporation at a low value without goodwill, coupled with a compensation shift. The third is the three entity approach with professional corporations or sometimes with the individual doctors as members or partners (in California or Hawaii).

Each business and tax structure of partnership consists of three categories. They are the associate buy-in, operations and owner buy-out. All categories need to be considered when the partnership is contemplated, hopefully prior to the associate picking up a handpiece. Why? Because if the practice owner's succession or exit strategy is definitive and a new doctor will be admitted as a future partner, the identity of the candidate will not matter. Dealing with these complex issues a year or two after the associateship begins will lead to disagreements, *e.g.*, purchase price and valuation date. This two-part article does not consider operations, which will be discussed in a subsequent article. Operations consist of allocation of compensation in all forms and benefits, decision making control and employment of family members.

I routinely encounter four tax risks related to the buy-in. They are compensations shifts, the "Anti-Churning Rules" under Internal Revenue Code ("IRC") Section 197, S-corporation distributions and worker classification.

Under all three structures, the buy-in is usually internally financed unlike the buy-out, which except for two or more owner and family practices can be paid in cash. The buy-in can be paid in cash if the practice entity and/or existing owner will act as a guarantor of the loan for the

¹ Ready, Set, Retire!, Dental Economics, Dr. James R. Pride and William P. Prescott, M.B.A., J.D., PennWell Corporation, July, 2001.

² As Chair, Closely Held Businesses Committee, American Bar Association, Section of Taxation, 2007-2009 Term, I organized and participated on a panel that discussed these risks which included a Small Business/Self-Employed representative from the Internal Revenue Service ("IRS") on May 8, 2009.

³ I was also asked to organize and participate on a similar panel by the American Bar Association for its Annual Meeting on July 31, 2009.

incoming owner. Because the existing owner is almost always asked to guarantee the loan, this would not be my recommendation because if the new doctor leaves the practice, the loan needs to be repaid. Because the buy-in will either be internally financed or the senior doctor will act as the guarantor of the loan, the senior owner often retains the tie-breaking vote or a 51% ownership interest in the partnership, at least until the first half or proportionate interest has been fully paid. Certain decisions, however, should be unanimous, e.g. the hiring of a new dentist or specialist, relocation/expansion, capital expenditures over a threshold amount or changes to the compensation allocation for owners.

Purchase and Sale of Stock in After-Tax Dollars

Where the incoming dentist or specialist acquires stock in a professional corporation, it can be burdensome for the incoming owner to make payments because they are made in after-tax dollars. A solution is to balance the tax benefit to the seller, who receives favorable capital gains treatment at this time, with the tax detriment to the purchaser, by adjusting the tax-neutral purchase price downward. Note that appraisals, with few exceptions, do not consider the tax effect of the business and tax structure. A properly completed practice valuation should indicate what the incoming owner can afford to pay, within a measured time period, without reducing the compensation and benefits received as an associate. Tip — no associate will take a pay cut to become an owner!

By valuing the stock at its fair market value inclusive of goodwill, the purchase price can be guaranteed under a promissory note and secured by a pledge of the incoming owner's stock under a pledge and security agreement. This assumes that the buy-in is internally financed, almost always the case in a partnership.

Because purchasing an interest in an existing entity can subject the purchaser to unknown or contingent liabilities, certain representations and warranties must be made by the practice and existing owner. The purchaser must complete a due diligence investigation on the practice and both doctors on each other. While the seller would hold harmless the purchaser from any liabilities arising prior to the partnership, a hold harmless is only as good as the economic strength of the seller. However, I have never seen any liability associated with stock purchased in over 20 years of practice and hope I never do. Of course, I am sure that there are exceptions.

By structuring the transaction in this manner, neither the seller nor purchaser need to be concerned with any recharacterization of the transaction in the event of an audit. Unfortunately, this business and tax structure is used the least. There is a delayed benefit to the purchaser, however. When the incoming owner later sells the stock, capital gains is paid only above the purchase price previously paid or the doctor's "basis" in the stock.

Stock At A Low Value Without Goodwill, Coupled With A Compensation Shift

Risk 1 – Compensation Shifts. Historically, this business and tax structure has been used to admit an incoming owner to a professional corporation by valuing its stock at a low value without the inclusion of goodwill; often the fair market value of the professional

corporation's tangible assets. To the extent that the transaction is structured as a stock purchase, the seller receives favorable capital gains treatment and the purchaser pays in after-tax dollars. To the extent that the goodwill portion of the buy-in is structured as a compensation shift, the effect to the seller is ordinary income while the new owner attains a pre-tax buy-in. For this reason it is common for the compensation shift or goodwill portion of the buy-in to be "grossed up" for the difference to the seller between capital gains and ordinary income and again for an interest component. But I don't get it! If the additional compensation above that for professional services is grossed up to cover the additional tax to the seller and again for an interest component, why not include the goodwill in the stock value? Adjust the value downward to reflect the tax detriment to the incoming owner purchasing stock in after-tax dollars and the senior owner receiving capital gains. This would eliminate any tax risk.

Under this popular business and tax structure, the incoming owner receives disproportionately less compensation than the senior owner during the first several years of ownership, e.g., seven. The idea is that the senior owner's interest is increased by compensation adjustments for the value of the professional services rendered to the practice, over time.^{4,5} While Footnotes 4 and 5 may provide some support for use of a compensation shift, I find no Tax Code Section or other cases that allow for a compensation shift as a means for the purchase and sale of an interest in a closely held business or professional practice. If this approach is used, there may be a guaranteed bonus to the senior owner who is arguably worth more to the professional corporation than the incoming owner. Assuming that the senior owner actually provides management and administrative services to the professional corporation, such doctor could be compensated for those services under a practice management agreement. The incoming owner's compensation is reduced by the sum of the management fees that the practice pays to the senior owner. However, management fees by their character cannot be secured so there is a potential risk of non-payment. Moreover, keeping track of a compensation shift is complex and often the accountant has difficulty making the calculations. With these types of buy-ins, it is not uncommon for the senior owner to feel like he or she has not been paid for the interest purchased and for the incoming owner not to comprehend how or whether the payments were made.

The Pediatric Surgical Associates case⁶ highlighted the importance that compensation paid to a shareholder/employee of a professional C-corporation equate to the value of both professional and non-professional services rendered. And guess what? Many practice owners contemplating a partner are organized as C-corporations. Here, the profit above the value of professional services rendered by the shareholders was found to be a non-deductible dividend. At the time of this case, I thought its result could have and may in the future pose a significant problem for compensation shifts because the additional compensation is not for professional services rendered and is almost always calculated from an appraisal of the goodwill of the

⁴ Muskogee Radiological Group, Inc. v. Commissioner, T.C. Memo, 1987-490.

⁵ Tax Planning For Corporations and Shareholders, Second Edition, Zolman Cavitch, Lexis Publishing, Matthew Bender & Company, Inc., 13.04[1], [2], [3].

⁶ Pediatric Surgical Associates, P.C. v. Commissioner, T.C. Memo 2011-81, April 2, 2001.

practice. A safe approach in light of the Pediatric Surgical Associates case may be for any practice organized as a C-corporation to pay a meaningful dividend each year, maintain a log of any and all non-professional services similar to a vehicle mileage log, and document the services in Minutes each year. As capital gains rates increase, expect another increase in the popularity of this business and tax structure.

In my view, however, the compensation shift on the buy-in is not the big problem. It is the buy-out which would be paid in cash and structured as the professional corporation's purchase of a combination of stock and personal goodwill. The tax risks relative to personal goodwill are discussed in Part II of this article.

Three Entity Approach

An increasingly common business and tax structure for partnerships is for the incoming owner to form an S-corporation and purchase an undivided one-half interest in the assets from the existing practice entity or owner. Advisors attempt to get amortization to the new owner through the purchase of assets and mostly capital gains to the existing owner because roughly 85% to 88% of an asset purchase and sale is allocated to goodwill. After the purchase, the new owner and existing owner operate the practice through a newly-formed limited liability company or partnership (in California or Hawaii) that collects the revenue, pays the operating expenses including employee benefits and employs the staff. Profits are distributed to the entities owned by the respective shareholders or doctors individually if there are no professional corporations. Each doctor owned entity, e.g., an S-corporation, pays the direct business expenses of each member or partner that may include liability insurance, continuing education, business travel, automobile, possibly technology used only by one owner and lab and/or any other direct business expense that may be disproportionate for one or more of the respective owners. General operating, staff, and occupancy expenses are usually paid pro rata, e.g., 50%/50% in a two owner practice. It should be noted that this approach may also include use of a compensation shift with the ramifications earlier discussed.

This business and tax structure carries the complexity of operating with three entities, along with the preparation of three tax returns. However, because the new owner does not purchase an interest in the existing owner's entity, there is no concern over the purchaser being subject to unknown or contingent liabilities. While this approach can work very well if the practice has engaged an accounting firm with experience in these types of business structures, there are other important issues to deal with.

Risk 2 — Anti-Churning Rules. Unfortunately, for those practices formed pre-August 10, 1993, the Anti-Churning Rules under IRC Section 197 deny amortization of the goodwill purchased by the incoming owners^{7, 8, 9}, if the existing owner and new owner jointly

⁷ IRC Reg 1.197-2(h)(2).

⁸ 1997 WL 33106671 Internal Revenue Service Field Service Advisory.

⁹ IRC Reg. 1.197-2(k) Ex. 18.

own twenty percent or more of the third entity¹⁰ or are family members. It is the third entity, the limited liability company or partnership, that creates the problem for non-related owners. IRC Section 197 does not provide for bifurcation of the goodwill for pre and post-August 10, 1993.¹¹ Worse yet, many advisors are not aware that the pre and post-August 10, 1993 cannot be bifurcated and do attempt to amortize it. 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 seller(s) and purchaser. In addition, under its Anti-Abuse Rules, the IRS may interpret and apply the rules under IRC Section 197 as necessary and appropriate to prevent avoidance of the purposes of IRC Section 197.¹² Therefore, there is authority for the IRS to recast the transaction. If an advisor believes that pre and post-August 10, 1993 goodwill can be bifurcated, an appraisal of such pre and post-August 10, 1993 is very important.

A possible way to avoid the Anti-Churning Rules is for the practice to form an affiliate at least one year prior to the sale. This partnership makes what is called an IRS Section 754 election and, at least one year later in an unrelated transaction, the senior owner sells an interest to the new owner.¹³

If, on the other hand, the owners operate separate practices under a solo group arrangement with no common ownership of a third entity, the goodwill is amortizable for the buy-in, except for family members. What's more, each separate practice may adopt its own tax-qualified retirement plan without covering the eligible employees of both practices. Shared employees, e.g., hygienists, can also be accounted for under a solo group arrangement. Notwithstanding the ability to amortize pre-August 10, 1993 goodwill, solo groups work well because the new owner is usually not required to purchase the existing owner's practice at retirement or other departure, but retains the option to do so. Because the practices are separate, the retiring owner can sell his or her practice to a third party dentist if the remaining owner does not exercise the option to purchase. Death or permanent disability usually requires a mandatory purchase.

Risk 3 — S-Corporation Distributions. Where the members of a limited liability company or partnership are S-corporations which is relatively common, another problem with the three entity approach relates to S-corporation distributions, which has the effect of eliminating the 2.9% Medicare tax above the Social Security wage base or retirement plan contribution level. Some advisors prefer a limited liability company or partnership of S-corporations so that S-corporation distributions can be taken. Note that the IRS dislikes S-corporation distributions to begin with and believes that this practice is being abused. Where

¹⁰ IRC Reg. 1.197-2(h)(6)(i)(A)(B).

¹¹Mergers, Acquisitions, and Buyouts, Martin D. Ginsburg, Jack S. Levin, December, 2002, Aspen Publications, 4-118, Example 17, Section 403.4.4.4.

¹² Reg. 1.197-2(j).

¹³ Reg. 1.197-2(k) Ex. 19.

the three entity approach is used and the operating entity is a limited liability company, there is authority^{14, 15} to suggest that the S-corporation distributions are unavailable and that all income flowing through the limited liability company is self-employment income, irrespective of the reasonableness of the distributions.

Risk 4 – Worker Classification. It is not uncommon for a limited liability company or partnership with S-corporations as members or partners to structure the transaction with the S-corporations as independent contractors to the limited liability company or partnership. Along with four IRS representatives, I was on a worker classification panel as a private practitioner.¹⁶ The panel considered three questions that I asked; can the new associate who may form his or her S-corporation or other entity qualify as an independent contractor, can the retired dentist or specialist who works as an associate through his or her practice entity or individually after retirement qualify as an independent contractor, and can the S-corporations or doctors under the three entity approach in a limited liability or partnership of S-corporations qualify as independent contractors? In all three instances, the conclusion was rarely. Where the practice bills the patients, sets and collects fees and schedules patients, and where the doctors are subject to restrictive covenants, there is probably sufficient behavioral control, financial control and relationship of the parties for an employer/employee relationship, irrespective of whether the doctors practice through S-corporations or another entity. Consultants often ask, "if the independent contractor pays its applicable taxes and the limited liability company or partnership pays its applicable taxes, no harm no foul, right?" That was the first question addressed by the lead panelist at my request. The answer was "no". If there is a misclassification, the employer would be assessed all federal income tax, penalties and interest with limited ability to get the funds back considering that the same tax cannot be collected twice. For the employee, those direct business expenses and benefits would, for the most part, be lost. It is clear to me that worker classification is once again becoming a priority of the IRS and the states relative to small businesses and professional practices.

Summary and Thoughts

Purchase and Sale of Stock in After-Tax Dollars

Where this business and tax structure is used, it can sometimes be challenging for the seller's advisor(s) to understand that the tax-neutral practice value must be adjusted downward to account for the tax detriment to the purchaser purchasing stock in after-tax dollars. Without the downward adjustment, this business and tax structure will not work because the economics will

¹⁴ Victor Grigoraci, et ux., et al. v. Commissioner, TC Memo 2002-202.

¹⁵ The Tax Advisor, February, 2003, 2-03 T.T.A. 80, American Institute of Certified Public Accountants, Inc., Thomas P. Ochenschlager, Partner, Grant Thornton, LLP, Washington, D.C.

¹⁶ In August, 2008, I participated in the first IRS Office of Chief Counsel Program in Atlanta. The Program lasted three days and the participants were the roughly 1,200 IRS lawyers.

not allow it. The same is true in a three entity approach where the Anti-Churning Rules apply to deny amortization of the goodwill purchased.

Stock At A Low Value Without Goodwill, Coupled With A Compensation Shift

If this business and tax structure is used, the compensation for the senior owner must equate to the value of the management services rendered. If the practice is organized as a C-corporation, it should pay a meaningful dividend each year, the non-professional services should be documented and Minutes should be prepared each year confirming that the services were rendered. The problem with this business and tax structure is that there is no authority to allow the purchase of an interest in a closely-held business or professional practice in pre-tax dollars.

Three Entity Approach

This business and tax structure works well if the practice was formed after August 10, 1993. If formed earlier, the goodwill for the buy-in is not amortizable and would be similar to the purchase and sale of stock in after-tax dollars. A solution would be to adjust the purchase price downward to reflect the tax detriment to the purchaser or attempt to utilize the compensation shift. Do not use S-corporation distributions as a reason to enter into this business and tax structure. As to worker classification, independent contractor relationships are not advisable.

Recommendation

Remaining a solo practitioner is best and practicing in a solo group, second best. If a partnership is entered into, any of the three business and tax structures can work if the tax risks are recognized and not taken. Advisors, if the doctors are being advised to enter a partnership where tax risks exist, they must be disclosed. In general, my recommendation for partnerships is the purchase and sale of stock in after-tax dollars, then reduce the buy-in price by the tax detriment for the new owner paying in after-tax dollars. It is simple, there are no tax risks and there is one entity. The three entity approach works well if the practice was formed after August 10, 1993.