

## Chapter 16

### **SELECTING YOUR PRACTICE ENTITY — S OR C CORPORATION, LLC OR SOLE PROPRIETOR<sup>1</sup>**

The discussion of entity choice is technical. However, choice of entity is both important to your practice and any other business you own relative to profits, taxes, succession and legal risks. Therefore, the purpose of this chapter is to provide you and your advisors with a reference of the advantages and disadvantages of operating and/or owning your practice, or any other business, e.g., the practice real estate, as a: (i) sole proprietorship; (ii) general partnership; (iii) limited liability company; (iv) limited liability partnership; (v) limited partnership; (vi) C corporation; or (vii) S corporation. Please note that dental practices do not operate as limited partnerships which have been traditionally used for family planning purposes.

Of the above entity forms sole proprietorships and general partnerships offer no liability protection to you as practice owner. Limited liability partnerships and limited partnerships provide for only partial limitation of liability to owner(s). The use of a business form which provides for limited liability should be considered as a form of insurance. However, you will always be liable for your alleged or actual malpractice. In addition, there are economic costs associated with the formation and maintenance of those entities which provide limited liability. Those costs should be weighed against the potential risk of liability.

In the Wall Street Journal on May 7, 1991<sup>2</sup>, an article indicated that there were over 100 million state court lawsuits filed for 1989; slightly higher than for 1988. This statistic does not include lawsuits filed in federal courts. If you consider the number of lawsuits filed in state courts each year as percentage of the population of the United States, then it is not too difficult to determine that any reasonable precaution which can be taken to guard against potential liability is prudent and well advised.

The limitation of liability to the owner(s) of the practice is generally the primary reason for its operating in an entity which limits the liability to the owner(s). However, there are certain tax issues which are relevant to the business form in which the practice operates. The goal with respect to tax matters is to legally turn non-deductible items into tax-deductible items, e.g., 100% deductibility of health insurance premiums to owners of C corporations.

In determining the proper form of business organization for your practice, the following four rules should be considered as guidelines.

First, the greater the number of employees in the practice, the greater the need for a business form entity which provides the owner(s) with limited liability.

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<sup>1</sup> William P. Prescott, MBA, JD The Limited Liability Company and Other Entities for Dentistry, 1996, the Expert Series for Dentists, Randall K. Berning and AMD Affiliates, Naples, Florida.

<sup>2</sup> Amy D. Marcus and Arthur S. Hayes, Legal Beat, "State Courts in '89 Got 100 Million New Cases as Tort Suits Rose 7.6%," The Wall Street Journal, Legal Beat, May 7, 1991.

Second, if there is more than one doctor in the practice, it is wise to utilize a business form which limits liability. Irrespective of the business form, you will always be liable for your own alleged or actual malpractice. However, unless you operate the practice in a business form which limits liability, you would also be liable for acts of the other dentists and employees in the practice. Additionally, you would have unlimited personal liability for the debts of the practice, which would not be the case if you operate the practice in a business form which limits liability, unless the practice debts were personally guaranteed by you.

Third, if you operate the practice as a sole practitioner, the business formats which would limit your liability would be a C or S corporation or a limited liability company, depending whether your particular state would allow a one member limited liability company to operate as a dental practice or limited liability company. C corporations should be considered when you desire to obtain tax-favored fringe benefits, e.g., 100% deductibility of health insurance premiums. However, tax-favored fringe benefits should be weighed against the potential double taxation at the corporate and shareholder levels when the corporation is ultimately sold. One method for avoiding the double taxation issue is through the effective use of an S corporation. However, S corporations cannot provide the tax-favored fringe benefits to owners as do C corporations.

Finally, those practices currently operating as C or S corporations should probably not convert the practice to a limited liability company. The conversion of a C corporation to a limited liability company would result in a tax at both the corporate and shareholder levels and an S corporation converting to a limited liability company would create a single level of tax. Therefore, the conversion of either a C or S corporation to a limited liability company would probably create a significant tax problem.

### **Limited Liability Companies**

An entity format first enacted in Wyoming in 1977 and then in Florida in 1982 is the limited liability company. While the majority of states have recently recognized limited liability companies, certain states still restrict dental and other professional practices from operating in this format. The states which do permit the formation and operation of a limited liability company now usually allow for one member as opposed to two or more owners. Obviously, prior to the formation of a limited liability company, the state statute in question would have to be reviewed in order to determine if dental practices are authorized to operate as limited liability companies. If so, it would be imperative to also review how the limited liability company would be taxed at the state level in comparison with other entities.

Limited liability companies generally desire to be treated as partnerships for federal tax purposes. This avoids the potential double tax issue when the practice is sold at both the corporate and shareholder levels which is a potential problem with a C corporation. Like a partnership, a limited liability company avoids tax at the entity level and passes through taxable income, losses and credits to the member, owner, level.<sup>3</sup> Alternatively, the members of a limited liability company receive limited liability comparable to shareholders of a C or S corporation.

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<sup>3</sup> "Limited Liability Companies: A Look at the New Kids on the Block," New Tax Times, Vol. 9, No. 4, Aspen Publications, Inc., April, 1995.

Limited liability companies would be useful for new practices or those practices which were previously sole proprietorship in general partnerships. Remember, existing practices converting to limited liability companies would be subject to a significant tax upon their liquidation and conversion to a limited liability company. Although the owners of the limited liability company would not receive the fringe benefits available only to owners of a C corporation, the owners would potentially have flexibility, pursuant to IRC Sections 736(a) and (b), upon the sale of the practice to structure the transaction in accordance with the tax needs of the parties, e.g., tax-deductible payments to the practice treated as ordinary income to the departing doctor vs. non tax-deductible payments to the practice treatment as capital gains to the departing doctor.

Although there is little case law and few IRS rulings to rely upon for the use of limited liability companies, I predict that this entity will substantially grow in popularity for two or more owners to operate the practice by reason of the IRC Section 736(a) and (b) payments, above. However, the tax treatment of IRC Section 736 payments to members of limited liability companies remains unsettled with the IRS at this time.

### **Formation of the Limited Liability Company**

Limited liability companies are formed by filing articles of organization in the state where the practice or entity is located. Articles of organization are similar to articles of incorporation regarding the formation of a corporation. The affairs of a limited liability company are governed pursuant to bylaws and/or an operating agreement, which is similar to a partnership agreement in a partnership or code of regulations (or a close corporation agreement) in a corporation. The individual elected by the members of the limited liability company to manage the affairs of the entity are the manager(s). The managers' role is similar to a managing partner of a partnership or the president of a corporation.

### **Check the Box Regulations**

The IRC 7701 entity classification regulations now allow for entities to elect how they will be taxed for tax purposes. The taxpayer makes a tax classification election by filing Form 8832 with the appropriate IRS service center.<sup>4</sup>

### **Self-Employment Tax**

Dentists forming limited liability companies which render professional services would be subject to self-employment taxes. Self-employment taxes include a member's distributive share, whether or not distributed, of income or loss from any trade or business carried on by the limited liability company. However, where the limited liability company does not render professional services, it is possible that the member would not be subject to employment taxes.

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<sup>4</sup> Roger E. Pillow, John G. Schmaltz and Samuel P. Starr, "Changing an Entity's Classification By Election: The First Modifications to Check-The-Box", *Journal of Taxation*, March, 1998, pg. 144.

## **The Limited Liability Company vs. Other Entities**

### **C Corporations**

The limited liability company has the tax advantage over a C corporation of flow through tax treatment, so the potential double taxation problem of C corporations is generally avoided. However, and as previously indicated, as profits of C corporations are generally paid to shareholders of dental practices as salary, bonuses, retirement plan contributions and fringe benefits, this problem is most applicable to C corporation distributions with respect to a partial or complete sale of the practice. For example, under IRC Section 311(b), the distributing C corporation would recognize gain on its distribution of appreciated property. Both the C corporation and shareholders recognize income; the corporation on its gain and the shareholders on their dividends.<sup>5</sup> This potential problem can be minimized by advanced planning and the proper and appropriate use of deferred and/or management compensation arrangements.

With regard to the decision to operate the dental practice as a limited liability company over a C corporation, it was previously indicated that certain statutory fringe benefits are available to owners of a C corporation which are unavailable in other entity formats. If fringe benefits are desirable to the practice owner, the use of a professional C corporation, as opposed to another entity, should be considered.

### **S Corporations**

There exist certain restrictions on S corporations that are inapplicable to the limited liability company, e.g., 75 shareholders, nonresident aliens, certain trusts and one class of stock. Although such restrictions may not affect the operation of the dental practice, such restrictions may affect other businesses which you may own.

An S corporation shareholder's basis is increased by loans made to the S corporation, but is not increased by his or her share of the S corporation's debt. The members of a limited liability company, which is taxed as a partnership, would increase their basis by their allocation of the limited liability company debt. Because tax is paid on gain above basis, e.g., due to the sale of the practice or the real estate, the use of a limited liability company may be more advantageous than an S corporation or other entity.

As to deductible losses, the amount of an S corporation's deductible losses is limited to the sum of the shareholder's basis in his or her stock and any loans from the shareholder to the S corporation. Alternatively, a member of a limited liability company, taxed as a partnership can deduct losses in an amount up to the sum of his or her basis in the entity, his or her share of limited liability company income and his or her share of the limited liability company debt.<sup>6</sup> Therefore, if the entity will incur losses, a limited liability company would be more useful to deduct such losses than would an S corporation.

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<sup>5</sup> Phillip G. Lilly, Esq., "Corporations, Partnerships and Limited Liability Companies," Addendum to Desk Reference Manual, National Education Network, Vermont, July 17, 1994, p. 8.

<sup>6</sup> *Ibid.*, pp. 10, 11.

## **General and Limited Partnerships**

The primary advantage of a limited liability company over a general or limited partnership is that of the limited liability provided to the members of the limited liability company, as opposed to the personal liability imposed upon general partners.

Under Treas. Reg. 1.752-2, "recourse liability" of the partnership (i.e., liability for which one or more partners bears the economic risk of loss, e.g., a loan personally guaranteed by one or more partners) is included only in the outside basis of such partner(s) in proportion to their respective obligations to discharge the liability. However, under Treas. Reg. 1.752-3, "nonrecourse liability" of the partnership, liability as to which no partner bears the economic risk of loss, is allocated to all partners in accordance with their respective profit interests. In a limited partnership, only true recourse liabilities and liabilities for which the limited partners bear the risk of loss through a personal guarantee or other arrangement are allocated to the limited partners, and all other liabilities are allocated entirely to the general partners. Therefore, the general partners usually benefit disproportionately more from basis increases arising from partnership liabilities than do limited partners.

In contrast, all limited liability company liabilities, other than those for which particular members bear the risk of economic loss, are considered to be nonrecourse because all members have limited liability. Therefore, all limited liability company members are allocated shares of such limited liability company liabilities and all limited liability company members may benefit from such allocation by increasing their basis proportionately.<sup>7</sup>

## **Conversion to Limited Liability Company Status**

Although general partnerships may generally convert to the limited liability company format without adverse federal tax consequences, Revenue Ruling 84-52, existing practices operating in a corporate format should be extremely cautious about converting to a limited liability company format for the following reasons. First, the dissolution of the corporation would be treated as a liquidation for federal tax purposes, thereby triggering a gain on the value of the corporation's assets in excess of the tax basis. Second, the value of the accounts receivable would be immediately taxed at ordinary income rates. Therefore, the limited liability company format (where permitted) would be only advantageous for new practices or practices currently operating as sole partnerships or general partnerships.

## **Other Forms of Business Organizations**

### **Sole Proprietorships**

A sole proprietorship is the simplest form of operating the practice because it does not involve the creation of a new entity nor the shifting of assets from one individual to another. All of the tax consequences of the practice are taken by you. However, you would also have

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<sup>7</sup> Ibid., pp. 11 - 13.

unlimited liability. To conduct a sole proprietorship, you would segregate a portion of your assets and dedicate them to practice use.

You may consider the use of a sole proprietorship when establishing your practice, assuming that the number of staff members employed is low and that there is only one doctor in the practice. Sole proprietorships are simple to operate and the cost of forming and maintaining the entity is low.

## **General Partnerships**

A general partnership is an association of two or more persons who intend to carry on the practice as co-owners for profit. A general partnership is treated as a separate entity for many purposes, but is generally not subject to federal income taxation. A written partnership agreement is not required. General partners, as opposed to shareholders of a corporation or members of a limited liability company, are subject to unlimited personal liability. Due to the unlimited personal liability, I would not recommend the use of a general partnership, except in rare circumstances.

## **Limited Liability Partnerships**

Many states permit general partnerships to register as limited liability partnerships. Limited liability partnerships provide limited liability to partners for the acts of other partners, unless the partner has direct supervision and control over the other partner. Limited liability partnerships are a variation of the limited liability companies. Although limited liability partnerships shield the liability of partners for the acts of other partners, limited liability partnerships are not as efficient as limited liability companies. Unlike a limited liability company, partners remain personally liable for the partnership's commercial liabilities.<sup>8</sup> The advantage of limited liability partnerships is that they offer significantly greater liability protection to owners than general partnerships and are relatively inexpensive to form.

## **Limited Partnerships**

A limited partnership is treated the same as a general partnership for federal tax purposes. However, unlike sole proprietors and general partners, a limited partner's liability is limited to the amount of his or her or its capital contribution. A limited partnership must have at least one general partner and must prepare and file a certificate of limited partnership. Unfortunately, the general partner is subject to unlimited personal liability to the extent of his or her interest in the entity.

Limited partnerships can be useful in certain family planning situations where valuation discounts are desired in order to transfer assets to other family members. However, these situations are subject to scrutiny by the IRS and great care should be exercised prior to entering into such an arrangement. For example, in order to take a valuation discount for lack of control or a minority interest, there must be a legitimate business where such elements are present.

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<sup>8</sup> "A Limited Liability Company Offers the Best of Both Worlds", Key Business Outlook, Society Bank, Vol. 3, Issue 1, Summer, 1995.

Generally, limited liability companies have essentially replaced limited partnerships in that the liability of the general practices can be avoided.

## **C Corporations**

A C corporation is a separate legal entity for tax and non-tax purposes. When earnings are distributed to the shareholders as dividends, they are taxed again. Unlike a partnership, a corporation is not merely a conduit for the profits and losses of the practice; rather, it is a separate taxable entity. However, shareholders of a C corporation have the advantage of not being liable for corporate obligations and being able to freely transfer their interests, subject to restrictions which may be agreed upon by the shareholders.

Much has been said about the potential double taxation of C corporation profits. In reality, this problem, if it occurs, will occur upon the complete or partial sale of the assets, not stock, of the C corporation. With regard to the double taxation of professional C corporation profits on a year-to-year bases, a professional C corporation typically reduces its taxable income to zero by paying out all of its earnings as compensation, salary, bonuses, retirement plan contributions and other fringe benefits, to the dentist/shareholder(s) or practice owner(s). Thus, there is no issue of double taxation of profits on an ongoing basis. This is not a problem when you are generating all of the corporate income or profits through the provision of professional services. However, in the event that the C corporation employs multiple non-shareholder dentists, your compensation would reflect more than your professional services. In this case, the IRS could potentially treat part of your compensation as a non-deductible dividend with resultant tax liability at the corporate level. This problem could occur in substantially large group practices, clinics or managed care facilities which employ a large number of non-owner dentists.

C corporations, by statute, provide the owner(s) of the entity with fringe benefits unavailable in any other entity format. It is for this reason that in appropriate circumstances, I recommend the use of this entity form for both sole practitioners and multiple owners.

## **S Corporations**

An S corporation has all of the non-tax attributes of a C corporation e.g., limited liability, but has elected to be treated under special rules which generally provide for taxation only at the shareholder level.<sup>9</sup> As in the case of a sole proprietorship or partnership, all losses and income flow through the corporation to the shareholder/owner(s).

Due to the problem of double taxation upon the sale of the practice, an S corporation is a very useful entity in which to operate the practice for both sole practitioners and multiple owners. However, the tax-favored fringe benefits which you would receive as an owner of a C corporation are substantially reduced for owner(s) of S corporations, e.g., limited deductibility of health insurance premiums for S corporations, as opposed to 100% deductibility for C corporation owners and no deductibility for disability premiums or group-term life insurance.

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<sup>9</sup> Tax Planning for Corporations and Shareholders, 2nd Edition, Cavitch, Matthew Bender & Co., Inc. Limited Liability Companies, Section 14.07[2].

## **Non-Tax Considerations Among Entities**

### **Limited Liability**

Persons organizing a dental practice or other business will often desire to insulate their personal assets from the claims of business creditors. This characteristic of limited liability is most readily available if a corporation, limited liability company, limited liability partnership or limited partnership is chosen as the business or entity form. Regardless of the form of doing business however, insurance may (and should) be used to protect you against personal liability.

### **Sole Proprietorships**

A sole proprietor has unlimited personal liability. His or her personal and business assets are subject to the claims of all personal and business creditors.

### **General Partnerships**

A partner in a partnership and a general partner in a limited partnership are both subject to unlimited personal liability. Generally, a partner is liable for the wrongful acts of his or her co-partners in the partnership as well as for the partnership's obligations.

### **Limited Partnerships**

Limited partners are insulated from liability for partnership obligations in excess of the limited partner's capital contribution to the partnership; provided, that the limited partner does not participate in the management of the limited partnership.

### ***Entities Providing Limited Liability/C and S Corporations, Limited Liability Companies and Limited Liability Partnerships***

The limited liability available to a C or S corporation's shareholders, a limited liability company's members or a limited liability partnership's partners is generally regarded as a major non-tax advantage in choosing the corporate, limited liability company or limited liability partnership form of business organization. Corporate shareholders, limited liability company or limited liability partnership members, absent any agreement or guaranty, generally will not be held liable for the entity's debts or liabilities. If limited liability exists, the shareholders' or members' losses will be limited to their individual investment in the corporation's stock, limited liability company's or limited liability partnership's investment. As a practical matter, however, shareholders of a closely held corporation or members of a limited liability company or limited liability partnership may be required to personally guarantee any financing the entity obtains from a bank or other creditor. Further, under certain circumstances, courts may disregard the separate nature of a corporate entity, i.e., "pierce the corporate veil", and hold the shareholders personally liable for the corporation's debts. This problem usually arises when corporate formalities are not adhered to.

No matter in which entity format the practice operates, professionals rendering professional services are liable for their own acts. However, the use of a C or S corporation,

limited liability company or limited liability partnership can protect you from the acts of other professionals in your practice. As a general proposition, the greater number of employees in your practice, particularly if there are multiple doctors, the greater the need to consider operating the practice in a format which limits liability.

### **Centralized Management**

The manner of conducting the practice, including the degree and necessity of formalities of operation, is an important non-tax variable to consider in deciding upon the entity form in which to operate.

### **Sole Proprietorships**

A sole proprietorship is not subject to any particular type of formalities. The sole proprietor is free to make decisions and engage in the practice without registration or qualification.

### **General Partnerships**

A general partnership is similar to a sole proprietorship in that there are few formal restrictions or formalities regarding the management of the practice. Except for any express written agreement between the partners, all partners have equal rights in the management and conduct of the partnership business. Any differences that arise in connection with the partnership business may be decided by a majority of the partners. Each partner is an agent for the partnership and can do anything necessary to operate the practice, such as hire employees, borrow money, or enter into contracts on behalf of the partnership.

### **Limited Liability Companies**

The management of a limited liability company is vested in its members in proportion to their capital contributions, unless otherwise provided in the operating agreement. Any member actively participating in the management of the limited liability company is generally considered an agent and may obligate the entity with respect to usual and customary business matters.

### **Limited Partnerships**

Limited partnerships possess a form of centralized management similar to that of a corporation. The limited partner risks only his or her investment, but must allow one or more general partners to exercise management control over the business. In fact, if the limited partner becomes involved in controlling partnership operations, he or she may lose his or her protected status as a limited partner.

### **C and S Corporations**

Both C corporations and S corporations have centralized management. This means that the management and control of the corporation is centered in one place—its board of directors. The directors are elected by the corporation's shareholders.

Apart from centralized management, the operation of a corporation requires many formalities which are not necessary in the operation of other business forms. The corporation must act in accordance with its code of regulations and articles of incorporation, hold meetings of its shareholders and directors, keep accurate records and minutes and file tax returns.

Corporate formalities can be considered both a benefit and a burden. While certain formalities may seem unnecessary, such formalities, e.g., the annual shareholder meeting requirement, may offer discipline to the practice and may serve to substantiate transactions for tax and other business purposes. Corporate formalities are set forth and maintained pursuant to the following documents in Figures 16-1 through 16-6.

- (1) Articles of Incorporation;
- (2) Code of Regulations;
- (3) Shareholders' minutes electing directors of the corporation; and
- (4) Directors' minutes electing officers of the corporation.

The Articles of Incorporation serves as the basic instrument authorizing corporate operation. It is filed in the state where the practice is located, authorizing the shareholder(s) to issue stock and operate as a professional corporation.

The Code of Regulations fill in the many procedural gaps not covered in the articles of incorporation and acts as a fail-safe for the authorities and powers of the shareholders, directors and officers of the corporation. In certain states, the term "by-laws" may describe this document.

The shareholders' minutes authorize the yearly requirement of the election of directors by the shareholder(s). The directors' minutes authorize the yearly requirement of the election of officers by the director(s). There are many other instances not covered in the examples where shareholders' or directors' minutes are necessary. Many state statutes authorize meetings of shareholders or directors without actually meeting, provided that the action taken by the shareholder(s) or director(s), as the case may be, is in writing.

Corporate formalities or transactions should be documented in the form of shareholders' and directors' minutes and certain agreements. The documented transactions include shareholder employment agreements, minutes for bonuses, primarily to shareholders, copies of leases, particularly where the professional owns the building, and the existence of promissory notes with regard to loans from or to shareholders.

The co-mingling of corporate funds with personal funds can allow a potential creditor or plaintiff of the corporation to pierce the corporation and assert personal liability against its shareholders, directors, and/or officers. In order to keep such funds separate, it is imperative for the corporation to maintain a separate checking account. Therefore, careful attention to documentation can assist to prove that there is no co-mingling of funds between the corporation and its shareholders and would be invaluable in the event of a lawsuit.

## **Continuity of Life**

The ability of a practice to continue after the death of one of its owners or upon the occurrence of an unforeseen event, such as the bankruptcy of one of its owners, is an important variable to consider in choosing the optimal form for the practice.

## **Sole Proprietorships**

In contrast to the death of a corporate shareholder, the death of a sole proprietor will terminate his or her practice. To maintain the practice value, a sole proprietor may provide in a will for the temporary operation of the business by a personal representative, a dentist, pending sale or liquidation or may have an arrangement through a local study club to temporarily operate the practice.

### ***General Partnerships and Limited Liability Companies***

A major disadvantage of operating as a partnership, which may be cured by written agreement, is that under most state laws, the death or withdrawal of a partner or member will generally result in dissolution of the partnership or limited liability company. Any partner or member may, at any time and even in violation of the partnership agreement, withdraw from the business and thereby dissolve the entity. However, a written partnership agreement may contain a provision which grants the remaining partners or members the right to buy-out the interest of the withdrawing partner and continue the operations of the practice or other business.

## **Limited Partnerships**

Even though a limited partnership lacks the perpetual existence characteristic of a corporation, a limited partnership may exist for a substantial period of time, since certain states provide that the certificate of limited partnership shall state the term of the partnership (which may be extensive). The limited partnership will dissolve at the expiration of the terms stated in the certificate of limited partnership. The certificate of limited partnership may also expressly empower a limited partner to substitute a new limited partner in his or her place. Death or withdrawal of all general partners, or the sole general partner, will generally terminate a limited partnership, unless the business is continued by the remaining general partners pursuant to rights granted in the limited partnership certificate.

### **Free Transferability of Interests**

## **Sole Proprietorships**

In general, a sole proprietor has complete freedom to sell or transfer any portion of his or her practice and make all decisions concerning its disposition or retention. There may, however, be general restrictions imposed by law, such as state licensing requirements.

### ***General Partnerships, Limited Partnerships, Limited Liability Companies***

Absent an agreement to the contrary, a partner in a general partnership, member in a limited liability company or general partner in a limited partnership must obtain the consent of all

partners or members to transfer a partnership interest and grant the transferee all the rights to which the transferor is entitled. Although this may be a disadvantage in some circumstances, the rule prevents an unwanted person from being thrust upon the partnership without consent of the existing partner(s).

## **C Corporations and S Corporations**

A corporation may be an effective and flexible practice or business form if transferability of interests is of concern. In the absence of an agreement, shareholders can freely transfer their shares. As a practical matter, it may be advisable to restrict the transferability of a shareholder's shares through the use of a buy-sell agreement.

## **Tax Considerations Among Entities**

There are numerous federal tax considerations to be evaluated before deciding on the appropriate form of practice organization. This text addresses the general tax considerations for each of the various forms of operating the practice. For purposes of this Section, members of limited liability companies and limited partners in limited partnerships are sometimes considered partnerships, as limited liability companies and limited partnerships are generally taxed as partnerships for federal tax purposes under the provisions of Subchapter K of the IRC.

## **Organization of the Practice**

### **Sole Proprietorships**

There are no federal income tax consequences when you practice as a sole proprietorship.

### **Partnerships**

In general, a partnership may be formed without the partners or the partnership recognizing taxable income. Specifically, IRC Section 721 provides that no gain or loss will be recognized by a partnership or any partner when property is contributed to the partnership in exchange for an interest in the partnership.

There are two key exceptions to the nonrecognition rule of IRC Section 721. First, when a partner contributes encumbered property to a partnership, the contributing partner may recognize gain. IRC Sections 731 and 741. Second, where a partner receives a partnership interest in exchange for services, rather than "property", the service-partner will recognize income. IRC Section 721.

### **C and S Corporations**

In general, a person transferring assets to a C corporation or S corporation will not generally trigger any tax consequences if the requirements of IRC Section 351 are satisfied. In general, IRC Section 351 requires: (i) a transfer of property; (ii) by one or more persons (the "transferors"); (iii) solely in exchange for; (iv) stock in the corporation; and (v) the corporation is "controlled", i.e. 80% or more ownership, by the transferors(s) immediately after said property transfer.

There are three key exceptions to the general rule of non-recognition. First, the transfer of encumbered property may cause a shareholder to recognize a taxable gain. IRC Section 357. Second, a shareholder who receives shares in exchange services will recognize gain. Third, a shareholder who receives property, i.e. "boot", other than stock from the corporation in exchange for the property contributed will recognize gain.

Example: A transfers real estate with a fair market value of \$50,000.00 and an adjusted basis of \$10,000.00 to a newly organized corporation in exchange for all of the corporation's stock, worth \$40,000.00, plus a short-term note having a fair market value of \$20,000.00. A's realized gain is \$40,000.00, fair market value of stock received, minus the adjusted basis of the property transferred. \$20,000.00, the fair market value of the note, will be recognized by A.

## **Taxability of Income**

An important tax consideration in choosing the form of practice or business organization is the manner in which profits and losses of the entity will be taxed.

### **Sole Proprietorships**

A sole proprietorship may be thought of as a conduit, similar to a partnership, limited liability company or an S corporation. This is because the practice is not a separate taxpayer and all of the tax consequences are the responsibility of the practice owner or proprietor. All profits or losses from the practice are attributable to the sole proprietor and must be reported on the sole proprietor's income tax return. IRC Section 61. Thus, unlike a C corporation, no problem of double taxation exists.

### **Partnerships**

General partnerships, limited liability companies and limited partnerships are similar to a proprietorship or an S corporation in that they are tax conduits rather than separate taxpayers. Items of income, losses, deductions and credits pass through to the partners, members or S corporation shareholders.

### **C Corporations**

A C corporation is a separate taxpayer, not a mere conduit. Use of a C corporation will generally result in double taxation: a tax at the corporate level on the corporation's profits, and a tax at the shareholder level if and when the corporation's after-tax income is distributed to shareholders as dividends.

Although double taxation may act as a deterrent to using the C corporate form, there are various techniques which may be used within reasonable limits to mitigate corporate double-taxation, including: (i) the payment of deductible compensation to shareholder-employees; and (ii) the payment of other deductible items, e.g., rentals, to shareholders.

## **S Corporations**

In general, S corporations are not subject to corporate-level taxes. Each S corporation shareholder takes into account separately his or her pro-rata share of items of income, losses, deductions and credits of the corporation. IRC Section 1336. C corporations which made the S corporation election after 1986 may be subject to a corporate-level "built-in gains" tax under IRC Section 1374, if the corporation disposes of certain appreciated assets within ten (10) years after the corporation has become an S corporation.

### **Deductibility of Losses**

A key tax consideration in choosing a form of business organization is whether losses generated by the practice or business may be utilized against an individual's other sources of income, or whether the losses will be retained by the entity to be offset against business income.

### **Passive Loss Rules**

Under prior law, losses from partnerships and S corporations flowed through to their owners and could be used to offset income from other sources. Since losses could not flow through a C corporation, it was advantageous to use a pass-through entity if losses were expected. Since both recourse and non-recourse liabilities increased the basis of a partner's interests and since losses could be deducted to the extent of a partner's basis in his or her partnership interest, subject to the "at-risk rules," if applicable, the partnership was the pass-through entity used by most businesses expecting significant tax losses. This tradition has been altered due to certain changes in the Tax Reform Act of 1986.

The 1986 Tax Act adopted IRC Section 469. This Section provides that "passive activity losses" can only be used to offset income from passive activities. A passive activity involves the conduct of a trade or business in which the taxpayer does not "materially participate," and by definition, includes any rental activity. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved on a regular, continuous and substantial basis in the operation of the activity.

### **Sole Proprietorships**

A sole proprietor may generally offset his or her other income with losses from the practice or business operation.

### **Partnerships**

Partners may utilize partnership losses against their own income, subject to the passive loss limitations and the at-risk rules, to the extent of his or her adjusted basis in the partnership interest at the end of the partnership year in which the loss occurred. Any unused loss is deductible in a year in which the partners basis in his or her interest is restored. IRC Sections 704(d), 465 and 469.

As to the determination of a partner's basis in partnership interest, IRC Section 722 provides that a partner's basis in his or her partnership interest equals the amount of money and

the adjusted basis of property contributed to the partnership, plus the amount of any gain recognized by the partner at the time of contribution. The partner's initial basis in his or her partnership interest is subsequently adjusted, upward and downward, to reflect partnership operations. Any increase or decrease in the amount of partnership liabilities will correspondingly increase or decrease each partner's basis in his or her partnership interest.

## **C Corporations**

A C corporation retains the use of its losses in the form of net operating loss carryovers which can be used to reduce corporate income in other years. The net operating loss carryover may be carried back three (3) years and carried forward fifteen (15) years. The shareholders of a C corporation are not able to deduct losses of the corporation against their other sources of income. Under IRC Section 469, "closely held" C corporations (which are not personal service corporations) may, however, use passive losses to offset "active income," but not "portfolio income", e.g., dividends. Therefore, it may not always be advisable for a C corporation with active income and passive losses to make an S election.

## **S Corporations**

The shareholders of an S corporation may deduct the losses generated by the corporation against their other sources of income, subject to the passive loss rules and at-risk rules. However, a shareholder's adjusted basis in his or her stock and corporate debt places a ceiling on the amount of losses he or she may deduct.

## **Partnerships vs. S Corporations**

Losses from an S corporation may be used to offset a shareholder's other income to the extent of a shareholder's basis for his or her stock, plus money loaned directly to the corporation, a shareholder guarantee will not suffice. IRC Section 1367.

A partner's basis may, in addition, include his or her share of partnership recourse and non-recourse indebtedness, which would be critical to realizing expected tax results from any real estate projects. Thus, in the context of a member of a limited liability company, one tax issue which should be considered is whether the member desires to be a manager or non-manager for purposes of deducting passive or active losses.

It should be noted that because the tax basis of an S corporation shareholder in his or her stock is not increased by any share of corporate level debt, non-recourse debt presents an unusual problem. If the debt is recourse debt or debt that the shareholders would otherwise have to guarantee, an S corporation should structure the loan as a loan from a financial institution directly to the shareholder, and then a subsequent loan from the shareholder to the corporation. However, when the shareholder would otherwise not have any liability on the debt, and because, in the partnership context (especially in real estate, when the at-risk rules may not apply), non-recourse debt can be used to increase a partner's basis, the facts may weigh heavily in favor of using an entity (e.g., limited liability company) which is taxed as a partnership.

## **Special Allocations**

In organizing a practice or business, another significant tax consideration arises if certain of the doctors or individuals seek the benefit of a disproportionate amount of losses or other items of deduction.

## **Partnerships**

In general, a partner's distributive share of income, gains, losses, deductions or credits is determined by the partnership agreement; provided, however, that the allocations have "substantial economic effect." IRC Section 704(a).

## **C Corporations**

A C corporation offers some flexibility in allocating profits and losses through the use of different classes of investment instruments (e.g., preferred stock, common stock, debt, etc.). Special allocation of deductions, such as depreciation, however, may not be allocated among C corporation shareholders.

## **S Corporations**

An S corporation may have only one class of stock (but voting and non-voting distinctions are permitted) and, therefore, its income and losses pass through to its shareholders on a pro-rata basis. Thus, special allocations are not generally available if an S corporation is used.

## **Choice of Fiscal Year**

### **Overview**

C corporations do not have restrictions on the use of a fiscal year other than a calendar year. On the other hand, certain other entities, i.e., S corporations, partnerships, personal service corporations, must use a "required taxable year" unless they can establish a business purpose for a different taxable year. The IRS has ruled that an entity can establish a business purpose for the use of a fiscal year other than a required taxable year if twenty-five percent (25%) of the entity's gross receipts for the immediately preceding twelve (12) month period fall in the last two (2) months of the entity's requested fiscal year, for the last three (3) years. Rev. Proc. 87-32. Taxpayers may still establish a business purpose for the use of a fiscal year based on all the facts and circumstances. The facts and circumstances test will, however, be narrowly construed. Rev. Proc. 87-57.

### **Required Taxable Years**

As to partnerships, the required taxable year is a taxable year used by one or more partners with an aggregate interest in the partnership profits and capital of more than fifty percent (50%). IRC Section 706(b)(1)(B)(i). The end result is that a partnership is normally required to use a calendar year.

With respect to S corporations, the required taxable year is a "permitted taxable year" under IRC Section 1378, i.e., generally a calendar year unless the S corporation establishes a business purpose other than a mere deferral of income.

Regarding personal service corporations, dental practices, a personal service corporation is a corporation which performs personal services as its principal activity, where over fifty percent (50%) of the compensation costs of the corporation are attributable to the performance of personal services. The required taxable year for a personal service corporation is a calendar year.

### **Code Section 444 Elections**

IRC Section 444 was added to the IRC of 1986 to permit certain entities to use a fiscal year other than a required taxable as follows:

#### **Adoption of Fiscal Year by New Entities**

IRC Section 444 permits a new entity to adopt a fiscal year other than a required taxable year but only if the "deferral period" is no longer than three (3) months (the number of months between the close of the taxable period and the close of the required year). As a result, the non-calendar alternative fiscal year ends are September 30, October 31 and November 30.

#### **Retention of Fiscal Year by Existing Entities**

In the case of an entity's first taxable year beginning after 1986, an entity may elect a taxable year which is the same as the last taxable year beginning in 1986. This rule allows an electing entity to use its fiscal year for 1987 and all subsequent taxable years. This election was available only if the election was made for the entity's first post-1986 taxable year.

#### **Existing Entities Changing to New Fiscal Year**

In the case of an entity changing its taxable year, an election may be made only if the deferral period is no longer than the shorter of: (i) three (3) months or (ii) the deferral period of the taxable year currently being used by the entity.

#### **Additional Restrictions**

In order for an entity to be entitled to use a fiscal year as set forth above, it must adhere to the following restrictions. Electing partnerships or S corporations must make estimated tax payments pursuant to IRC Section 7519. Further, electing personal service corporations are subject to limitations on the amount of deductions it can take for payments to employees/owners unless certain minimum distributions are made.

#### **Accounting Method**

Under IRC Section 448, a C corporation may be required to use the accrual method of accounting if it has gross receipts in excess of \$5 million per year, which is rarely applicable to a dental practice. S corporations and partnerships are exempt from accrual method requirement.

## **Non-Liquidation Distributions**

### **Partnerships**

IRC Section 731(a) provides that a distributee partner will not recognize any gain or loss on the distribution of property unless he or she receives cash in excess of his or her basis in the partnership interest. Under IRC Section 731(b), a partnership will not recognize any gain or loss on the distribution of money or property to a partner. A partner's/partnership's recognition of taxable income may occur if a partner receives money or property in exchange for a part of his or her interest in the partnership attributable to "unrealized receivables" or inventory items which have appreciated "substantially" in value. IRC Section 751.

### **C Corporations**

Non-liquidating distributions of a C corporation will be taxable as non-deductible dividends to the extent of the C corporation's earnings and profits. Any amounts received in excess of earnings and profits will be treated as a return of capital to the extent of a shareholder's basis in his or her stock. IRC Sections 301 and 312. Amounts received in excess of a shareholder's basis will be treated as a gain from the sale or exchange of stock.

In addition, the corporation will have taxable income to the extent the fair market value of any property distributed exceeds the corporation's adjusted basis in the asset. IRC Section 311.

### **S Corporations**

Distributions from S corporations (which have no earnings and profits) will not be taxable to the extent of a shareholder's basis in his or her stock. Amounts received in excess of an S shareholder's basis in his or her stock will be treated as gain from the sale or exchange of the stock.

Distributions from S corporations which have accumulated earnings and profits are entitled to treatment as distribution from S corporations without accumulated earnings and profits to the extent of the accumulated adjustments account, "AAA". The AAA generally represents the total amount of taxable income of the corporation since attaining S corporation status, less any distributions. Distributions exceeding AAA are treated as dividends to the extent of the corporation's accumulated earnings and profits. Distributions in excess of accumulated earnings and profits will be taxed for S corporations with no earnings and profits.

Like C corporations, an S corporation will recognize gain to the extent the fair market value of the distributed assets exceed the corporation's adjusted basis. IRC section 1363(d). However, this gain increases the shareholder's basis in his or her stock and thus increase the likelihood that the amount of the distribution will be less than the shareholder's adjusted basis in his or her stock and, therefore, tax-free.

## **Termination of An Owner's Interest/Sale of the Practice**

### **Partnerships**

Partnerships and limited liability companies offer a flexible statutory scheme with respect to transactions designed to partially or completely terminate the interest of an owner. If a partner sells all or part of his or her interest to another, the purchaser may enjoy certain tax advantages if the partnership files a Section 754 election to adjust the basis in its assets. Partnerships and limited liability companies do, however, have at least one potential drawback in regard to sale or exchanges of partnership interests. The sale or exchange of fifty percent (50%) or more interest in the profits and capital of a partnership during a twelve (12) month period causes a constructive termination. IRC Section 708(b)(1)(B).

Cash payments to a retiring partner may be structured with flexibility. Payments are classified into two categories: those made for the partner's interest in partnership property, "Section 736(b) payments"; and all other payments, "Section 736(a) payments". Section 736(b) payments are treated similar to the rules applicable to non-liquidating partnership distributions (previously discussed). Section 736(a) payments may be structured as either non-liquidating distributions or deductible guaranteed payments. The retiring partner would desire to have the payments comprise Section 736(b) payments and be taxed as capital gains. On the other hand, both types of Section 736(a) payments may result in favorable tax consequences to the continuing partners.

As a further explanation, when a general partner in a professional partnership leaves active practice, the partner or his/her estate may be entitled to continuing payments which reflect his or her portion of the partnership goodwill. If the partnership agreement does not provide otherwise, these payments will be deductible by the partnership and ordinary income to the recipient under IRC Section 736(a). However, the professional partnership agreement could provide that such payments are consideration for partnership property, with the result that the partnership would not be entitled to a deduction and the recipient would have capital gains. IRC Section 736(b). Therefore, in a professional partnership, the partners can negotiate to determine their tax consequences.<sup>10</sup> Because limited liability companies should be taxed as partnerships under Subchapter K of the IRC, the same flexibility may be available to members of limited liability companies as partners in partnerships to negotiate the tax consequences with respect to the departure of a member.

### **C and S Corporations**

In contrast to partnerships, redemptions of a shareholder's stock are governed by IRC Section 302 which prescribes objective and subjective rules regarding whether the transaction is to be treated as a sale or exchange of stock or as a distribution with regards to stock, i.e., dividend. If the transaction is treated as a sale or exchange of stock, the departing shareholder may offset his or her gain realized with his or her stock basis. Payments by the corporation for

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<sup>10</sup> Tax Planning for Corporations and Shareholders, 2nd Edition, Cavitch, Matthew Bender & Co., Inc., Limited Liability Companies, Section 14.07[2][c].

corporate stock are non-deductible. However, it is possible to achieve the results allowable under the partnership tax rules (e.g., deductible guarantee payments) by utilizing deferred and/or management compensation arrangements or other appropriate, reasonable and bona fide arrangements.

## **Valuation Issues**

The value of a practice does not generally change as a result of the entity form in which the practice operates. However, I recommend that the value of the practice be adjusted (upward or downward) in accordance with the tax benefits or detriments to each party of the transaction once the structure of the sale is determined.

For example, if a dentist acquiring a practice is purchasing the stock of a C corporation, such stock purchase is non-deductible to the acquiring dentist and is taxed as favorable capital gains rates to the selling dentist. In such a situation, it may be appropriate to reduce the fair market value of the practice to reflect the tax detriment to the acquiring dentist and the tax benefit to the selling dentist.

Alternatively, if the above transaction were structured to include a significant element of deferred compensation, the fairness of the tax attributes may be equalized. The payment of deferred compensation would generate a 35% tax benefit to the acquiring dentist, who would now own 100% of the C corporation stock, and would be treated as ordinary income to the selling dentist. If approximately half of the sale and acquisition were structured as a sale of stock and the remaining half were structured as payments of deferred compensation (if appropriate under the circumstances), the tax attributes may be balanced and no adjustment to the fair market value of the practice would be necessary.

The general rule concerning the fair market value of the practice in light of the entity form in which it operates is that if one party to the transaction receives a tax benefit to the detriment of the other party, an adjustment (up or down) to the fair market value may be appropriate.

## **Liquidations**

### **Partnerships**

With some exceptions, distributions in liquidation of a partnership are generally governed by the same rules which apply to non-liquidating distributions from a partnership. IRC Section 736.

### **C Corporations**

There are two levels of tax incurred in liquidating a C corporation. Due to the demise of the general utilities doctrine, a corporation is now taxed on the difference between the adjusted basis and the fair market value of the assets distributed. At the shareholder level, the second tax is based on the difference between the fair market value of the assets received and the shareholders' adjusted basis in their stock. See IRC Sections 331 and 336. This is the double taxation problem applicable to C corporations. This problem can arguably be avoided in the event that the goodwill

of the preferred corporation can be considered as the personnel goodwill of the doctor(s)/shareholder(s).

## **S Corporations**

Under IRC Section 1363(d), an S corporation will generally recognize gain on the distribution of appreciated property in complete liquidation. As with non-liquidating distributions, the recognition of gain will increase each shareholder's basis in his or her stock. This gain recognition increases the possibility that the fair market value of the property distributed will be less than the shareholder's basis in his or her stock and, therefore, tax-free.

A corporate level tax may apply under either "old" IRC Section 1374, for capital gains of S corporations which elected before January 1, 1987, or "new" IRC Section 1374, for "built-in-gains" for former C corporations which made post-1986 S corporation elections. Under old IRC Section 1374, S corporations, which had switched from C status within the last three years, were subject to a corporate level tax if the net capital gain of the corporation exceeded \$25,000.00 and also exceed 50% of its taxable income, and the taxable income of the corporation exceeded \$25,000.00. This old version may apply to former C corporations which elected S status before January 1, 1986. Former C corporations which elect S status after December 31, 1986 will have to pay a corporate level tax on the amount by which the fair market value of the corporation's assets at the time of the S corporation election exceed the corporation's adjusted basis in such assets at the time of the election (if such gain is recognized within a ten (10) year period).

## **Income Splitting**

An important tax consideration is the potential for splitting the income of the business among the members of the family, such as children, who may be in lower tax brackets than you.

## **Sole Proprietorships**

There is no real potential for income splitting unless a child or other member of a family is employed by the sole proprietor. Employment of a child or other family member will enable the sole proprietor to retain profits among his or her family, and still receive a deduction for payment of a salary to a family-member employee.

It should also be noted that shifting income to one's children will not work if the children are under 14 years of age, since the child's unearned income, subject to minor adjustments which presently shield a small amount of unearned income, will be taxed at the same rate as the parents pursuant to the so-called "kiddie tax." IRC Section 1(i).

## **Partnerships**

The use of a partnership to shift income among family members has long been a popular device. Congress responded to the many abuses for this mechanism by enacting IRC Section 704(e) which allows the IRS to collapse a family partnership and reallocate partnership income if certain objective and subjective criteria are not met.

## **C Corporations**

A C corporation may be utilized to shift income among family members. Subject to the kiddie tax rules, for businesses other than the dental practice, transferring shareholder ownership to other family members will be sufficient to shift income (e.g., dividend distributions).

## **S Corporations**

Subject to the kiddie tax rules, S corporations may effectively shift income among family members who own stock in the S corporation. Of course, due to state licensing requirements, the dental practice is not generally applicable to this discussion. However, it should be observed that if an individual who is a member of the family of one or more shareholders of an S corporation renders services for or furnishes capital to the corporation without receiving reasonable compensation, the IRS may make such adjustment in the items taken into account by such individual and such other shareholders as may be necessary in order to reflect the value of such services or capital. IRC Section 1375.

## **Qualified Retirement Plans**

Before the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), retirement plans were a significant factor in deciding whether or not to incorporate. Benefits available under tax-qualified corporate plans were substantially greater than under plans of unincorporated entities or S corporations that benefited only one or more "self-employed individuals," such self-employed plans were known as KEOGH Plans. TEFRA, eliminated the special rules for KEOGH Plans maintained for self-employed individuals and enacted parity for deduction and contribution limits between corporate and non-corporate plans. After TEFRA, with certain exceptions, retirement planning is tax-neutral factor in choice of entity decisions. Similarly, the Subchapter S Revision Act of 1982 generally repealed the special limits and rules that treated shareholders in S corporations as if they were self-employed for these purposes.

Some differences still remain in the treatment of retirement plans sponsored by corporations and those maintained by self-employed individuals who are owner-employees, i.e., generally defined as sole proprietor, partner or member owning more than ten percent (10%) interest in the capital or profits of the entity. First, contributions to plans maintained for self-employed individuals are based upon "earned income," which is defined as net earnings from self-employment as suggested by IRC Section 401(c)(3). For unincorporated entities, deductions are permitted only to the extent of net earnings from self-employment. IRC Section 404(a)(8). Thus, the contributions to the plan are not considered in the net earnings. The effect of this restriction is to change the formula for non-corporate plans. For example, for defined contribution plans, the maximum contribution for a participant of an unincorporated entity is twenty percent (20%) of earned income (rather than twenty-five percent (25%) of the shareholder's W-2 compensation).

Second, plan loans to sole proprietors, partners and members owning more than ten percent (10%) share of an entity are "prohibited" transactions under ERISA and are subject to a penalty tax. Plan loans to owners of more than five percent (5%) of an S corporation stock are also a prohibited transaction. Although plan loans to a shareholder of a C corporation entail numerous restrictions because of recent legislation, plan loans, up to \$50,000.00, are still

permitted to be made to such individuals without incurring prohibited transaction penalties. Section 408(d) of ERISA; IRC Section 4975(d); IRC Section 72.

Third, certain rules apply to require the aggregation of plans of all trades or businesses which are considered a "controlled group" because of ownership interest. Employees of the controlled group must be covered by the plans on a non-discriminatory basis. Sole proprietors and ten percent (10%) partners are generally subject to more owner controlled group rules than are shareholders of corporations.

Finally, it is more advantageous for a self-employed individual to establish a Keogh Plan rather than a Simplified Employee Plan, "SEP", since a Keogh Plan is not subject to creditors' claims in bankruptcy. Since a SEP is in essence a "large IRA" and IRAs are not protected in bankruptcy, the SEP is similarly attachable by creditors and is not protected in bankruptcy.