

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 II – The Owner Buy-Out

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To ensure compliance with the requirements imposed by IRS Circular 230, we inform you that any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (1) avoiding tax-related penalties under the Internal Revenue Code or (2) promoting, marketing or recommending to another party any tax-related matter(s) addressed herein.

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

PART II – THE OWNER BUY-OUT

This is Part II of a two-part article on the benefits and tax risks under the three basic business and tax structures of partnership. Part II covers owner buy-outs, while Part I dealt with associate buy-ins.

The first business and tax structure of an owner buy-out is the purchase and sale of stock in after-tax dollars under a buy-sell agreement. The second is the professional corporation's redemption or purchase of stock at a low value without goodwill, coupled with the professional corporation's purchase of personal goodwill or payment of deferred compensation. The third is the three entity approach with professional corporations and sometimes with the individual doctors as members or partners (in California or Hawaii).

I routinely encounter three tax risks related to the buy-out of an owner. The three tax risks are the purchase of the departing owner's personal goodwill by the professional corporation, the professional corporation's payment of deferred compensation under Internal Revenue Code ("IRC") Section 409A and the "Anti-Churning Rules" under IRC Section 197.^{1, 2}

For the buy-out in a two owner practice, the remaining sole owner can use the practice as security to obtain the loan for the buy-out, so we would like the buy-out to be paid in cash. This eliminates any risk of default on payments over time. An exception is a two or more doctor practice where a third or additional owner is being admitted. This is because doctor two, already an owner, will not desire to be affected by a third or additional doctor's purchase of the retiring or departing owner's interest. These buy-outs are typically seller financed. In three or more doctor practices, the buy-out of an owner is even more complex and the obligations, not options, of the younger doctor(s) to buy-out the senior doctor(s) interest(s) should be agreed upon in advance, along with the business and tax structure of doing so. The buy-out of an owner would be in accordance with the buy-sell agreement(s) under any of the three business and tax structures and the purchase price would be determined by formula, pre-agreed value or appraisal. There may be more than one buy-sell agreement. For example, there may be a buy-sell agreement for the purchase and sale of stock or a membership/partnership interest, another for personal goodwill and another for deferred compensation. Partnerships can be complex!

¹ 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.

² 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.

Purchase and Sale of Stock in After-Tax Dollars

The buy-sell agreement formula, pre-agreed purchase price or appraisal should consider the tax detriment to the purchaser purchasing stock in after-tax dollars and the price must be adjusted accordingly. There is no tax risk under this business and tax structure. Finally, the purchase of stock can be easily insured through the use of insurance for death, although disability buy-out insurance is relatively costly and availability is limited.

Stock At A Low Value Without Goodwill, Coupled With The Professional Corporation's Purchase of Personal Goodwill or Payment of Deferred Compensation

Risk 1 — Personal Goodwill. Here, the stock of the departing shareholder is redeemed or purchased by the professional corporation at a low value without goodwill, coupled with the professional corporation's purchase of the departing shareholder's personal goodwill. The advantage of this business and tax structure is to the extent that there is personal goodwill, the purchaser which is the professional corporation, may be able to amortize the personal goodwill over 15 years while the purchase of stock cannot be amortized. To the retiring or departing owner, the personal goodwill may, arguably, be taxed at capital gains at one level and not double taxed. This buy-out structure is based upon the facts of two 1998 cases^{3, 4}. There are two additional cases in 2008 to support that personal goodwill does exist^{5, 6}. Notwithstanding this, the purchase and sale of personal goodwill can still be challenged. If this method is used, the shareholder being bought out cannot be subject to non-competition provisions with the practice while a shareholder under the two 1998 cases. This point alone effectively eliminates this common business and tax structure. This is irrespective of whether the entity is a C-corporation or S-corporation. For example, if a C-corporation, the goodwill is double taxed at 35% at the corporate level and again at 15% at the individual level. If an S-corporation, there could be either a termination of the S election due to a disproportionate distribution or redemption or purchase by the professional corporation of shares of the departing shareholder. Additionally, it is important to have an appraisal that distinguishes the personal goodwill of a retiring or departing owner versus any corporate goodwill. The appraisal of the personal goodwill would be included in the buy-sell agreement formula. Unfortunately, few appraisers will prepare this special type of appraisal.

Interestingly, we are now dealing with transactions where doctors who own practices that purchased personal goodwill are retiring. There will be depreciation recapture for amortization previously taken for personal goodwill earlier purchased at ordinary income rates.⁷ The effect of

³ *Martin Ice Cream v. Commissioner*, 110 T.C. No. 189 (1998)

⁴ *Norwalk v. Commissioner*, T.C.N. 1998-279

⁵ *Muskat v. U.S.* 554 F. 3d 183

⁶ *Solomon v. Commissioner*, T.C. Memo. 2008-102, 208 WL 1744406 (U.S. Tax Ct.)

⁷ IRC Section 1245.

depreciation recapture at the time of a later buy-out should be considered by the CPA for the purchaser at the time of negotiation for the buy-in.

Lastly, the Anti-Churching Rules deny amortization of the personal goodwill by the professional corporation if the practice was formed pre-August 10, 1993, as discussed below.⁸

Where a third owner is admitted, this approach is complicated because it is the professional corporation, not the third owner, that purchases the personal goodwill of the senior owner as it is the trade or business. Unless the second owner agrees to participate in the buy-out of the senior owner, the purchase of the personal goodwill gets complicated. Where used, this buy-out is usually handled through internal allocations so that the second owner is unaffected.

Risk 2 — IRC Section 409A. Prior to the two 1998 cases on personal goodwill, shareholder buy-outs were often and sometimes still are structured with stock being purchased by the professional corporation at a low value without goodwill, coupled with the payment by the professional corporation of deferred compensation. Payments for deferred compensation are deductible to the professional corporation.⁹ However, deferred compensation is ordinary income to the recipient and there is little security to the departing shareholder for payment other than a personal guaranty of the remaining shareholder due to the nature of compensation. Unfortunately, deferred compensation arrangements, including the payment for accounts receivable, are now subject to the complexities of IRC Section 409A and the agreements must be drafted in accordance with its regulations. Additionally, IRC Section 1060(e) may impose future informational reporting requirements for deferred compensation and similar arrangements. Finally, the Treasury Regulations require that a "Top Hat Exemption Form" be filed with the Department of Labor within 120 days after any deferred compensation agreement is signed.¹⁰ The failure to file the Top Hat Exemption Forms will result in penalties and failure to comply with IRC Section 409A results in immediate taxation of all deferred compensation and a 20% penalty on the entire sum of the deferred compensation.

Three Entity Approach

Risk 3 — The Anti-Churning Rules. If the practice was formed prior to August 10, 1993, the buy-out under the three entity approach as well as the professional corporation's purchase of the personal goodwill is subject to the IRC Section 197 Anti-Churning Rules.¹¹ Therefore, goodwill would not be amortizable by the purchaser as there is no provision for bifurcation of pre and post-August 10, 1993 goodwill¹². This is because of the 20% or more

⁸ The Tax Advisor, September, 2009, 9-09 T.T.A. 573, Thomas J. Brecht, CPA, Elkhart, IN.

⁹ Revenue Ruling 60-31; Internal Revenue Code Section 409A.

¹⁰ Labor Reg. 2520.104-23.

¹¹ IRC Reg. 1.197-2(h)(2).

¹² Mergers, Acquisitions, and Buy-Outs, Martin D. Ginsburg, Jack S. Levin, December, 2002, Aspen Publications, 4-118, Example 17, Section 403.4.4.4.

common ownership of the third entity or professional corporation. Where a family member is buying out a relative, there does not need to be 20% common ownership for the Anti-Churning Rules to apply which disallows the amortization pre-August 10, 1993 goodwill. This applies to a complete purchase and sale of a practice without partnership or common ownership where the buyer and seller are related.

Summary and Thoughts

Purchase and Sale of Stock in After-Tax Dollars

It is usually difficult for the seller's advisor(s) to understand that the buy-out formula, pre-agreed purchase price or appraisal must be adjusted downward to account for the tax detriment to the purchaser purchasing stock in after-tax dollars. The same is true in a three entity approach for the purchase of a membership interest in a limited liability or partnership where the Anti-Churning Rules apply.

Stock At A Low Value Without Goodwill, Coupled With The Professional Corporation's Purchase Of Personal Goodwill Or Payment Of Deferred Compensation

For the senior shareholder to be bought out in cash upon retirement or other departure, the practice would purchase his or her personal goodwill. If so, the senior shareholder cannot be subject to a restrictive covenant with the practice. An appraisal of the personal goodwill is also necessary. Additionally, we would want the accountant for the practice to determine what, if any, effect that depreciation recapture will have on personal goodwill previously purchased. Finally, if the practice was formed pre-August 10, 1993, the Anti-Churning Rules apply and the personal goodwill cannot be amortized.

If deferred compensation is paid by the professional corporation to the retiring or departing owner, the provisions of IRC Section 409A must be complied with and, on a practical level, there is a risk of default because other than a personal guarantee of the remaining shareholder, there is little security for payment.

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-out is not amortizable and would be similar to the purchase and sale of stock in after-tax dollars. The solution is to adjust to purchase price downward to reflect the tax detriment to the purchaser. If the doctors are related, e.g., father/son or daughter, etc., the goodwill is not amortizable even in a complete purchase and sale if the practice was formed pre-August 10, 1993.

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 well if the tax

risks are understood and not taken. Hire advisors with experience in these transactions and expect tax risks to be disclosed. In general, my recommendation for partnerships is the purchase and sale of stock in after-tax dollars, then reduce the buy-out formula, pre-agreed purchase price or appraisal by the tax detriment to the remaining owner paying for stock in after-tax dollars. It is simple, there are no tax risks and there is one entity. However, the three entity approach works well if the practice was formed after August 10, 1993.