Tax Planning Ideas for Your Transition

January 19, 2015

I have discussed, in prior articles, that one can tilt a practice buy-in very heavily toward the purchaser or seller; depending on one's perspective. Unfortunately, we see the great majority of brokered deals doing this in favor of the seller. As you know, I am a great proponent of making the deal a win-win for both sides and this technique has allowed us to fashion just such a win-win result.

In many cases, the selling doctor is operating the practice as a professional corporation. Regardless of whether the owner has made an "S Election" for federal tax purposes, the practice is still a corporation for state law and substantive legal purposes. The tangible assets (e.g. dental and office equipment, furniture and fixtures, tenant improvements, etc.) are all owned by the corporation.

Most practice purchases are done (and should be) as asset purchases; as opposed to stock purchases. In a stock purchase, the buyer acquires no depreciable basis and therefore is at a dramatic *disadvantage* from a tax perspective. The reasons for this can be addressed in another article; but suffice it to say that it is easier to balance the tax consequences to both parties in an asset sale.

When selling doctor is selling assets, he is selling two kinds: tangible and intangible. We have discussed the most prominent intangible asset - goodwill - in previous articles. We have also discussed how it is a *personal* asset and does *not* belong to the corporation (If you would like another copy of this article, just let me know).

The tangible assets clearly *do* belong to the corporation.

When a seller causes his corporation to disgorge and sell these assets to the buying doctor, he triggers what is called, in the tax planning world, a "constructive liquidation".

This doesn't mean that the corporation actually liquidates for state law purposes; but it means that it is treated as *having* liquidated, for *tax* purposes.
The result of this is that ALL of these assets are treated as sold by the corporation; thus resulting in a "taxable event" and triggering gain to the seller.

Now, you may be thinking that the gain will be taxed as capital gain (currently 20%); but this is not necessarily true. In fact, the bulk of the gain will probably be taxed at ordinary income rates (the highest current rate being 39.6%) and if the corporation is a "C Corporation" (traditional, non-S Corp), the tax rate will be about 60%. The reason for this ordinary tax treatment relates to "recapture".

When you buy equipment or other tangible assets for your practice you gladly depreciate those assets (under, say, Section 179) and take the deductions as quickly as you can: that's just good tax planning. When you sell those assets the tax man says that you have to give those deductions back. Since you took the deductions against ordinary income, they are returned as ordinary income and hence the ordinary income rates are applied to the gain on the sale of those assets by your corporation. This is recapture.

Instead of having our clients suffer this recapture, we get creative!

Instead of selling the assets to the partner, we keep the assets in the corporation and *lease* those assets to a new partnership, or LLC. In other words the new partners create a new partnership of S Corps, or an LLC and the seller transfers his personal goodwill to the new entity. The new entity (called NEWCO) then leases the tangible assets from the seller's old corporation (called OLDCORP).

Both doctors in their new entity will take an immediate write off on the lease payments each year, as "ordinary and necessary" business expenses (IRC Section 162); just like team salaries, or any other business expenses.

After five years or so, we will re-value the tangible assets and, if they have any value at all, they can be transferred to NEWCO with very little, if any, recapture. Any tax that is remaining can be paid with funds available in OLDCORP.

This approach allows buying doctor to write off his lease payments currently and allows selling doctor to avoid the nasty hit of recapture.

Both doctors receive tax benefits and, as usual, we do it in a way that is perfectly legal for tax purposes. Think, for instance, of how you own your facility in a separate LLC and lease it back to your practice entity. This is the same concept.

This strategy has to be set up very carefully; but it can be a powerful planning concept.