Tax Planning Tips for Your Transition

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I thought I would share a couple of common tax issues with you.

One of the most common questions that we get is: should I classify my associate as an independent contractor (IC); or as an employee?

In the vast majority of cases, the answer to this question is that you should treat the associate as an employee.

There is a great deal of bad advice floating around out there and it often sounds very attractive. The argument goes like this: the associate forms his own corporation and then leases his services to the practice, in exchange for fees/compensation (in lieu of salary). In this way, the associate doctor may maintain her own retirement plan and write off many "business expenses, which would be non-deductible as an employee. At the same time, the practice owner can avoid paying payroll taxes on the contractor.

If this sounds too good to be true; that's because it is!

About 80% of IRS collections come from payroll taxes and they get very touchy about the type of mischaracterization described above.

The IRS follows some very simple guidelines when determining whether an associate is an employee, or can be properly classified as an IC. These guidelines look at control issues, such as: who controls the associates hours of work; who controls the amount of compensation; who provides the staff assisting the associate; who provides the equipment and supplies, etc.?

If the answer to these questions is, "the practice", then the associate is an employee. If the answer is the associate himself, he may well be an IC.

As you can see from these guidelines, the vast majority of cases will result in the doctor being classified as an employee.

The misclassification of an employee as an IC can be extremely dangerous and expensive. Non-payment of payroll taxes due to this misclassification can result in penalties of up to 80%; plus interest. Repeated offenses can result in criminal prosecution.

Payroll tax audits are some of the most common and are extremely painful. Again, the Service is very protective of its payroll taxes.

It is important to note that there *are* legitimate ICs. An example of a legitimate IC might be an endodontist who visits your practice twice a month, in order to handle the molar endo that you don't want to do. This doctor brings his own microscope, files and other equipment and supplies; he establishes his own fees; pays his own insurance premiums; brings his own assistant and maintains his own retirement plan. This is an example of a legitimate IC.

The IC “trap” is a dangerous one! Don’t get lured in by the attractive “benefits” and don’t let some advisor tell you that “no one ever gets audited on this…” That’s not true; these audits happen all of the time and you will lose!

Another very common question that we get, is: does my corporation own my practice goodwill; or is this a personal asset, belonging to the doctor?

The intangible asset, commonly known as goodwill, is also commonly misunderstood. Goodwill is generally the largest single component of practice value and its proper tax treatment is not only misunderstood by dentists; but by their lawyers and accountants as well. Let’s review the definition of goodwill and how it should be treated for transition purposes.

Definition: Goodwill is the common term for all of the intangible things that cause people to come into your practice for dentistry. It includes, among other things: office location, staff, reputation, doctor resume and CE, office environment, specialization, if any, etc.

In short, all of the little things that cause folks to know you and respect you are part of goodwill. When valuing a practice, you may think that all of your technology and furnishings and tenant improvements are the largest component of value. In fact, goodwill usually comprises 50-80% of practice value.

Prior to the adoption of the new Internal Revenue Code of 1986 a buyer of goodwill, as part of a practice purchase, was not able to treat it as a depreciable asset; that is, be able to deduct the cost basis over the useful life of the asset. In 1986 Section 197 was added to the Code and this section allows a buyer of goodwill to write off, or expense, the asset over a flat 15 years.

As to the seller, the goodwill is treated as a capital asset and the gain on the sale of this asset is capital gain. Capital gains are currently taxed at 20% for federal purposes. Things get a little tricky in determining who owns the goodwill; or who is the seller? In a situation where the doctor is operating his practice as a professional corporation (PC) and has not made an S Election, the corporation is a taxable entity (C Corp). We all know that when the doctor has a C Corp/PC and there are profits remaining in the corporation at the end of the year, the taxpayer will “bonus” those profits out to himself; in order to avoid the corporation being taxed on those profits. The so-called double taxation of a corporation can usually be avoided in this way.

The good news is that the goodwill is NOT a corporate asset; but a personal one. So it should not be carried on the corporate books. The personal nature of goodwill was determined, famously, in the *Norwalk* case. In this case the Tax Court logically ruled that if there was no non-compete in place when Mr. Norwalk sold his interest in his accounting firm, he could simply walk across the street and set up shop. In that event his clients would come right back to him. They would do this because of their personal relationship; not because of the existence of some legal entity called a corporation. Therefore, the court reasoned, the goodwill was personal to Mr. Norwalk. This case is frequently overlooked by professionals.

Proper valuation and tax treatment of this asset is crucial.