Restructuring Your Business Entity in Preparation for Your Transition

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Many practices are still organized as Professional Corporations (PCs) and this reality presents us with some interesting issues when transitioning in a new partner. This article discusses some of the nicer issues in dealing with PCs.

I have frequently written about the merits of the Limited Liability Company (LLC), as an operating entity for dental practices. The reason that LLCs (or their counterpart Professional Limited Liability Company (PLLC)) are such wonderful legal entities is that they have all of the benefits of corporations and none of the deleterious tax consequences.

The old Professional Corporation is something of an anachronism. For this reason, newly formed dental practices and many long-established ones are reorganizing as LLCs. This makes a lot of good sense; but must be done with care; or it can trigger some negative tax consequences.

When an associate is buying into a practice as a partner, or as the new owner, it must be done in a win-win way. We must balance the tax and legal benefits/detriments. Failing to do this will cause imbalance and resentment. This is one of the primary reasons for partnerships failing.

There are two ways to buy into a practice which is organized as a corporation: the buyer can purchase stock in the corporation, or assets of the corporation. If the transaction is designed as a stock purchase the seller realizes capital gain on the value of the stock. The stock sale is very nice for the seller, because capital gains are taxed at a preferential rate of 20%. The other side of this coin is that the buyer of stock acquires no depreciable basis. In other words, the buyer cannot write off any of his purchase price as a business expense: not a very satisfactory result for buyer.

The disparity in tax treatment of buyer and seller in a stock purchase is the reason that the vast majority of these transaction are completed as asset sales.

When a corporation sells its assets to an incoming owner, the IRS treats the transaction as a complete liquidation of the corporation. This means that any gain on the sale is taxed to the corporation. The current highest corporate tax rate under the new law (*Tax Cut and Jobs Act of 2017*) is 21%. After the corporation is taxed, the shareholder seller is taxed on the property dividend recognized by the distribution of the assets sold to the buyer. This dividend, if taxed at the highest individual rate, is taxed at a rate of 37%; resulting in a potential tax to the seller of 58%! This is obviously not an optimal result for the seller.

How do we deal with this conundrum?

One answer, is to execute the transaction as a stock sale and discount the purchase price paid by the buyer; in order to compensate him for the loss of the tax deductions. We have structured deals in this fashion; but it still leaves the new shareholder(s) stuck in a corporation.

The better solution is to create a new entity (an LLC, we'll call "Newco") and transfer all operations of the practice to it. All of the tangible assets owned by the old corporation (let's call it "Oldcorp") will be leased to Newco; just as the facility is leased to the practice. This equipment lease will allow the practice to continue in a seamless way; but not require the "constructive liquidation" of Oldcorp.

The personal goodwill of the owner is contributed to Newco and all new equipment purchases in the future are made by Newco. In this way we have "sealed off" Oldcorp. Its assets are leased for a term (say five years) and at the end of that term we will re-value the assets. As the assets are five years older, they are worth substantially less and thus the taxable gain has been largely eliminated. Any tax liability that still exists can been paid with the cash in the corporation earned from the lease payments.

In this sort of structure, the buyer will acquire two things: stock in Oldcorp and membership units in Newco. The partners in Newco will write off the lease payments as an ordinary and necessary business expense. The buyer will also write off the goodwill purchase as a "Section 197 Intangible".

In this way, we have balanced the tax benefits and yet moved the business forward as an LLC.

This is an ideal solution for the selling doctor who wants to grow his practice, by bringing in an associate/partner; *but finds himself "trapped" in a corporation, with a substantial "built-in gain"*. This type planning works whether the owner is operating as a C Corporation or an S Corporation.

Some states don't allow dentists to operate as an LLC (California for example). In these jurisdictions we do a work-around, which involves a partnership of S Corps.

These transactions can be complex; but if handled by an expert and not thrown together by a broker, they can be completed in a way that assures a long and happy partnership.