

What You Can Do Now to Avoid Double Taxation on the Sale of Your Dental Practice

The proper classification and treatment of goodwill can mean the difference between paying double taxation and getting taxed once at the much lower personal capital gain rates.

Goodwill is an intangible asset owned by a dental practice or its owner that represents the value of its reputation with its patients, referral sources, and employees. It also represents the value that a buyer is willing to pay for the practice above and beyond the fair market value of its tangible assets, such as furniture, equipment, supplies, inventory, and leasehold improvements.

The main distinction between personal goodwill and practice goodwill comes down to whether the individual dentist or the practice has the ownership rights to it.

C Corporations

This distinction is most problematic for C corporations, since ultimately, the gain from the sale of goodwill will be subject to the ordinary flat income tax rate at the corporate level (21% federal rate, plus applicable state and city corporate tax). It would then be taxed a second time (double taxation) when the funds are distributed by the corporation to the individual shareholder (which would be taxed at the applicable individual federal capital gains rate, plus state and city tax rate).

Having an employment contract that includes a non-compete clause between the owner dentist and their dental practice could result in the goodwill being owned by the practice. For this reason, it is not recommended for a dentist to have an employment contract between themselves and their own practice that includes a non-compete clause. If one exists, it should be formally terminated well in advance of the practice sale.

It is also important to note that if the name of the practice is the same as the name of the dentist who is selling the practice, this makes for a much stronger argument that personal goodwill exists.

An appropriate allocation of a portion of the sales price to *personal* goodwill can avoid the double taxation on a portion of the gain. Under the right circumstances and through careful planning, personal goodwill can offer significant tax benefits to the seller, and at the same time, could put the buyer in a better position for negotiating a purchase price.

Pass-Through Entities

For pass-through entities that are treated for federal tax purposes as a partnership, S corporation, or sole proprietorship, the gain on the sale of practice goodwill can be taxed at the lower personal capital gains tax rate. Best of all, this will eliminate double taxation at the federal level and, *in most cases*, at the state and local level as well.

State and Local Tax Considerations

An important, but very often overlooked, tax issue is that some state and local governments do not recognize the Subchapter S status that can still subject the practice sale to double taxation at the state and local level.

For example, New York City does not recognize the Subchapter S status, and therefore will impose a New York City corporate tax on the gain of the goodwill, even if it is categorized as personal goodwill on the federal and state corporate tax return. The New York City corporate tax rate is 8.85%; therefore, a gain of \$300,000 from the sale of goodwill (practice or personal goodwill) will be subject to an additional \$26,550 in tax.

If there was no employment agreement with a non-compete, then the gain from the sale of goodwill would be taxed at the dentist's personal capital gain rate. It is important to also note that, in addition to the corporate contract to sell the tangible assets of the practice, there must also be a separate contract between the buyer and the dentist selling their personal goodwill (intangible asset), as well as the covenant not to compete. The sale's proceeds from the sale of personal goodwill should be paid directly to the dentist (seller) and not to their dental practice.

The IRS may scrutinize the claim of personal goodwill, so the dentist should follow these 6 steps to properly position themselves in the event of an audit.

- 1) If the selling dentist has an employment agreement with his practice that includes a non-compete agreement or other restrictive covenants, then these provisions should be removed, or even better, the entire employment contract should be officially terminated. You want to ensure that there are no documents that indicate the goodwill is controlled by the practice. Ideally, this should be done at least a year in advance or as soon as possible.
- 2) Document that personal goodwill exists early in the sale's process. Even before the sale and during negotiation, the seller should emphasize their personal relationship with patients, referral sources, and employees.
- 3) When possible, an independent personal goodwill appraisal would be best. If not, every attempt should be made to quantify the value of the personal goodwill.
- 4) The contract between the buyer and seller should include required steps the seller must take to transfer the personal goodwill to the buyer, such as a formal announcement letter to patients and referral sources.
- 5) A reasonable amount must also be allocated from the sales price to the seller's post-sale non-compete. The non-compete should also be paid directly to the seller, to avoid double taxation.

- 6) If the seller agrees to continue to provide consulting services and clinical work after the sale, they must be paid a reasonable compensation separate from the sales proceeds.

It is extremely important that you work with an attorney, as well as a CPA, who specializes in working with dentists and practice transitions, to ensure your sale is properly structured and you meet the criteria for personal goodwill treatment.

If you are considering the purchase or sale of a dental practice in the near future, please feel free to reach out to me for guidance.