Structuring Buyouts for Retiring Professionals

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Impact of Choice of Entity

- The choice of entity and buy in structure will dictate the format of the buyout.

- State licensing requirements for professionals may limit state law choice of entity.

- Does the entity have corporate goodwill, as opposed to personal goodwill?
  - If no, then easier to get out of corporate format if desired.

- Is there a desire to attempt to minimize self-employment tax?
  - If yes, then S corporation should be considered.
Impact of Choice of Entity

- How many owners does the entity have?
- How many employees does the entity have?
- Does the entity provide non-professional services?
- Is the entity affiliated with a non-professional entity?
Valuation

**Valuation Methods**

- Asset based approach.
  - Tangible assets.
  - Goodwill.
    - Personal goodwill vs. corporate goodwill.
    - Goodwill Registry published by Health Care Group, Inc. in Pennsylvania sets forth goodwill information for many professions.
    - 30 factors, but primarily based upon collections and profitability.

- Capitalization of earnings.

- Comparison to similar practices.
Corporate Structures

Redemption

- No basis increases for remaining professionals.
- Should be treated as sale or exchange under Code Section 302.

Gorin pp.72-81
Corporate Structures

Cross Purchase

- Allows for outside basis step up for non-retiring professionals.
- Cumbersome if entity has many professionals.
- Consider using if two professionals with non-compete in place.

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Considerations in Buyout Structure

Lump Sum Cash Payment Option

- Retiring professional receives cash up front with no economic risk.

- Retiring professional recognizes capital gain as opposed to ordinary income.

- Junior professional must obtain third party financing.
  
  - Repayment of loan is made with after-tax dollars.
Considerations in Buyout Structure

Deferred Compensation Option

- Total payment should be larger.

- Retiring professional has economic risk.

- Retiring professional will recognize ordinary income, but entity will be able to deduct payments.

- Need to be careful in setting terms of deferred compensation payment trigger under Code Section 409A.
  - Can use fixed date, but may need to take into account fact that retiring professional may continue to provide services after fixed date.
  - Can use change of control as payment starting date but it is difficult to satisfy requirements.

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Deferred Compensation

Overview

- Agreement to pay employee or service provider in the future for services provided in a current year.
- Entity does not receive a current income tax deduction for amount of deferred compensation.
- Employee or other service provider does not recognize income in year in which services are provided.
- Impacts balance sheet of entity since liability should be recorded pro rata each year as the service provider becomes vested.

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Deferred Compensation

Section 409A

- Need written plan in place when legally binding right to compensation exists.
  - Best practice is to put written plan in place when succession plan is created.
  - If not done, can argue right to compensation did not exist until written plan was adopted even if not contemporaneous with succession plan.

- Severe consequences if fail to comply.
  - Imposes 20% penalty on deferred compensation received by service provider.
  - Service provider must pay interest on deferred income tax.
  - Income tax is accelerated when violation occurs.

Gorin pp. 7-10
Deferred Compensation

**Section 409A**

- Permissible triggering events.
  - Separation from service.
  - Disability.
  - Death.
  - Specified time.
  - Fixed schedule.
  - Change in control (may be difficult to use).
  - Unforeseen emergency.

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Deferred Compensation

Imposition of FICA and Income Tax Liability

- FICA liability on deferred compensation is imposed on the date when the employee or service provider is vested even though payment is made at a later date.
- Income tax liability is imposed when payments are made to the employee or service provider.

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Personal Goodwill

- Goodwill is a capital asset.

- Purchaser of goodwill must amortize over 15 year period under Code Section 197.

- Strong argument that personal goodwill exists for professionals because of relationship between professional and client.

- Does professional have non-compete?
  - If yes, then no personal goodwill.
  - If no, then balance risk of professional leaving and competing vs. tax benefit of personal goodwill payment.
  - If no, then need valuation of personal goodwill vs. corporate goodwill.

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Personal Goodwill

- Can personal goodwill be sold by retiring professional to junior professional with junior professional able to amortize cost over 15 years?
  - Issue of deductibility by junior professional if entity is C Corporation.
    - Likely Schedule A itemized deduction.
    - AMT concern.
  - If entity is S Corporation, then deduction will likely be taken on Schedule E of junior professional’s return to offset S Corporation income.
  - If entity is partnership, then deduction can be specially allocated to the junior professional under the partnership agreement.

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**Partnership Structures**

**Redemption**

- Professional 1
- LLC interest

- Professional 2
- LLC interest

- Retiring Professional
- LLC interest
- Cash/note/deferred compensation

Professional LLC

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Partnership Structures

Cross Purchase

- Cumbersome if entity has many professionals.
- Consider using if two professionals with non-compete in place.

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Partnership Tax Issues

**Code Section 736**

- Governs treatment of payments to retiring or deceased partner.

- Code Section 736(a) payments are either treated as guaranteed payments (if fixed in amount) or as a distributive share of partnership income.

  - Will produce ordinary income to recipient partner, but generate income tax deduction for remaining partners or deflect income from remaining partners to retiring partner.
  
  - Fixed payments to a retiring partner are not subject to self-employment tax.

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Partnership Tax Issues

- Code Section 736(b) payments are treated as distributions by the partnership in exchange for partnership property.
  
  - Will produce mix of ordinary and capital gain income to recipient partner.
  
  - Payments for unrealized receivables cannot be treated as Code Section 736(b) payments.
  
  - The partnership agreement must specifically state that a payment is being made in exchange for goodwill under Code Section 736(b), or the payment will be reclassified as a Code Section 736(a) distribution.
  
  - If partnership agreement is silent on the issue and a Code Section 754 election is in place, then likely result is that payment will be a Code Section 736(b) distribution even if parties want Code Section 736(a) to apply.

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Partnership Tax Issues

- Code Section 736 payments involve various income tax liability deferrals.

- Retiring partner recovers basis before recognizing gain in contrast to installment sale in which each payment will likely have gain recognition.

- Retiring partner is not required to recognize interest on the deferred payments as is the case with an installment sale.

- Amortization of goodwill indirectly acquired begins with each separate annual gain recognized under Code Section 736 in contrast to a direct installment sale of goodwill, in which case all amortization of goodwill begins when the promissory note is delivered.

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Assume that value of practice is comprised solely of goodwill and that capital gain rate is 20% and ordinary rate is 40%.

The scenario in left column assumes that the junior professional uses after-tax dollars to fund buyout of the retiring professional’s interest. The scenario in the right column assumes the junior professional deducts payments to the retiring professional.

<table>
<thead>
<tr>
<th>Capital Gain to Retiring Professional</th>
<th>Ordinary Income to Retiring Professional</th>
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</thead>
<tbody>
<tr>
<td>Profit</td>
<td>$ 167</td>
</tr>
<tr>
<td>Tax to JP ($ 67)</td>
<td>($ 0)</td>
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<tr>
<td></td>
<td>$ 133</td>
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<td></td>
<td>$ 133</td>
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<tr>
<td>Tax to RP ($ 20)</td>
<td>($53)</td>
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<tr>
<td></td>
<td>$ 80</td>
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</tr>
</tbody>
</table>

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Comparison of 736(a) and 736(b)

**Code Section 736(b) Double Taxation**

- **Professional Practice Income**: $167
  - Ordinary Tax Income: $167 \times 40\% = $67

- **Junior Professional**: $100
  - Capital Gain Tax: $100 \times 20\% = $80

- **Retiring Professional**: $80

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Comparison of 736(a) and 736(b)

**Code Section 736(a) Single Taxation**

- **Professional Practice**: $133

  Ordinary Tax Income: $133 \times 40\% = $53

- **Retiring Professional**: $80

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Law Firm Example

- Successful attorney with practice in high-volume low-value case area of law wanted to begin succession plan with younger attorneys.
  - Practice was operated as a C corporation, but made S election as part of succession plan.
  - State ethics rules preclude attorneys from entering into non-compete agreements.
Law Firm Example

- Preferred LLC interest structure to comply with disguised sale safe harbor under Code Section 707 Regs.
- LLC makes guaranteed payments to attorneys, but make no distribution of profits.
  - If junior attorneys leave the practice, their capital accounts are forfeited.
  - Forfeiture of capital account is permissible under state ethics rules.

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Dental Practice Example

- Dr. Senior began practice in 1990 and would like to transition ownership to Dr. Junior.

- Dr. Senior prefers to be bought out for cash upon the earlier of his death, disability or retirement.

- Dr. Junior expects that Dr. Senior will enter into a non-compete agreement.
Dental Practice Example

- What business and tax structures should be considered.
  - Purchase and sale of stock in after-tax dollars.
  - Sale of stock excluding goodwill
  - Three entity method.
  - Solo group arrangement.
Estate Planning Issues

- Intra-family succession planning not as likely to be present.

- Valuation disputes with the IRS not as likely since buyout formula in shareholders agreement should control because of unrelated third parties.

- Professionals often have large qualified plans as part of estate.

- Asset protection issues more of a concern.

- Carefully structure life insurance arrangements to avoid Code Section 2042 inclusion.

- Income in Respect of Decedent.
  - Estate may recognize income upon receipt of a portion of redemption proceeds attributable to unrealized receivables.
  - Estate may take income tax deduction for estate tax imposed on IRD.