Closely Held Businesses from Start to Finish - Part III - The End

ABA Tax Section Joint Fall Meeting
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Moderator:
Galina “Allie” P. Petrova, Petrova Law PLLC, Greensboro, NC

Panelists:
Robb Longman, Longman & Van Grack, LLC, Bethesda, MD
William P. Prescott, Wickens Herzer Panza, Avon, OH
Emily A. Plocki, Venable, Washington, DC
Justin T. Miller, BNY Mellon, San Francisco, CA
Agenda

Robb Longman
• The Entity Matters—Sales of C corps., S corps., LLCs, and Partnerships
• The Form Matters—Asset Sales Versus Stock Sales

William P. Prescott
• Sales of Professional Practices with Substantial Goodwill—e.g., Dentists, Veterinarians, Psychologists and Ophthalmologists

Emily A. Plocki
• Pre- and Post-transaction Charitable Gifting and Estate Planning—e.g., CRTs, IDGTs and GRATs

Justin T. Miller
• Qualified Opportunity Zones
• Qualified Small Business Stock
• Nongrantor Trusts and Incomplete Gift Nongrantor Trusts
The Entity and Form Matters

Robb Longman
Asset Purchases vs. Stock or Interest Purchase
Robb Longman, Esq.
Longman & Van Grack, LLC
(301) 291-5027
rlongman@lvglawfirm.com
Asset Purchase vs. Interest Purchase

• Liability Issues
• Passthrough vs. corporation
• Valuation issues
• Personal goodwill vs. business goodwill
C-Corporations
Asset Sale

- Double taxation on assets sales.
- Income recognized by Corporations when the asset is sold.
- Income recognized in distributions to the shareholders.
- Even with the reduced corporate tax rate a significant amount can be loss to taxes.
- Double taxation can be reduced in part for sale of personal good will as opposed to business good will-also recognized in individual non-competes.
- Preferred method of the purchaser to help avoid liability issues.
Stock Sale

• Taxation on one level for seller.
• Issues are raised on basis of assets.
• Preferred method on seller.
• Liability issues in civil matters still exists.
Passthrough entities
Types of passthroughs

• S-Corporations

• Partnerships

• Sole-Proprietorships.
Asset Sale

- All income passes through to individuals.
- Allocation of assets to be determined.
- Company does not recognize any income.
- S-Corporations pass through income directly to shareholders.
- P-Ship will recognize both ordinary and self employment income on the income recognized.
- No liability to pass.
Stock Sale

• Income recognized as capital gain by sellers.
• Basis issues on assets that have been depreciated.
• Liability on transfer issues.
Professional Practices
William P. Prescott
Exit Strategies for Dentists

William P. Prescott
Wickens Herzer Panza
35765 Chester Road • Avon, OH 44011-1262
Phone: 440/695-8067 • Fax: 440/695-8098 • Cell: 440/320-8984
Email: WPrescott@WickensLaw.com
Website: www.PrescottDentalLaw.com

Complete Sale and Purchase

- Locating a successor
- Simple — is a complete sale and purchase the best choice? If so, why?
- Payable in cash, except for very large practices
- Tax favorable asset treatment for seller and purchaser, except possibly for personal goodwill when assets of C-corporations are sold
- Personal goodwill — based on case law\(^2\); the importance of personal goodwill valuations and Forms 8594
- Practices with significant insurance providers — consider stock sale treated as an asset sale
- Post-sale employment vs. independent contractor status\(^3\)


\(^3\) "Worker Classification: A continuing problem", *Dental Economics*, October 2017.
- Selling to a corporate buyer
  - Desire full payment at closing
  - Holdbacks based upon performance
  - Converting a fee for service practice to a reduced fee practice
  - Staff pay and benefits
  - Required continued employment; termination — breach by corporation provision
  - Onerous restrictive covenants and solicitation provisions for the selling dentist
Co-Ownership/Partnership

- Complex

- Unless Dr. Senior's practice and/or Dr. Senior guarantee Dr. Junior's loan, not recommended, the buy-in will be internally financed; coordinate buy-in percentages with significant S-corporation distributions

- Three categories
  - The buy-in
  - The buy-out
  - Operations
    - Allocation of compensation and operating expenses
    - Decision making control
    - Employment of family members

- Three business and tax structures
  - Stock including goodwill
  - Stock excluding goodwill
  - The three entity method
    - The anti churning rules apply for practices formed prior to August 10, 1993

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4 American Bar Association, Section of Taxation, Panel, Section 197 and Personal Goodwill in Professional Practices, May 10, 2019, Washington, D.C.
Mandatory vs. optional buy-outs

The buy-out in a two owner practice can be paid in cash because Dr. Junior uses the practice as security for the financing.

New challenge - junior owners unwilling to complete mandatory buy-outs — two owner practices versus larger groups where younger owners are required to buy-out older owners.

Dispute resolution provisions are always necessary.

For large practices, meaningful minority ownership and the ability to leave.

Numerous forms of co-ownership/private v. corporate and combinations.

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6 Chart: Forms of Group Practice; Chart: Emerging Trends in Group Practices.
Hire Associate with Later Complete Sale

- One owner — avoids complexities of co ownership/ partnership
- Good alternative where existing owner will work seven years or less
- Sell practice in one to three years and work as an associate for three or four years if the practice has sufficient patients
- Seller paid in full at closing

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8 "The dental associate contract" (Part 2), Dental Economics, June 2017.
Solo Group

- Two practices/one location
- Don't forget the buy-sell and dispute resolution provisions for the practice and real estate
- Who stays and who leaves in the event of an irreconcilable dispute?
- No mandatory buy-out by the new owner of the second half the existing owner's practice
Merger

- Good alternative for a smaller practice where remaining/transferring patients are difficult to define
- Equipment is usually not needed
- Usually paid on a contingent basis, e.g., one-half down and the remainder paid one year later based upon patients who transfer
- Good source of new patients for an under producing associate
Walk Away

- The economics are surprising favorable
- Is there another choice?
Considerations for All Exit Structures

■ Can the owner afford to retire?
■ What will the owner do with his or her time?
■ Entity dissolution\(^9\)
■ The real estate\(^{10}\)


### Chart: Forms of Group Practice

<table>
<thead>
<tr>
<th>Type of Group Practice</th>
<th>Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Two-doctor practice</td>
<td>Most common form of small groups</td>
</tr>
<tr>
<td>Specialty group</td>
<td>Buyouts are usually deferred compensation; the first to get out is in the best position</td>
</tr>
<tr>
<td>Multispecialty group</td>
<td>Same type of specialist is needed for buyout</td>
</tr>
<tr>
<td>Private practice — general and multispecialty medical building or condo</td>
<td>Perfect</td>
</tr>
<tr>
<td>Group with more than one family member</td>
<td>Third-party needs a buyout of the restrictive covenant</td>
</tr>
<tr>
<td>Part-time group</td>
<td>Quasi-office sharing arrangement</td>
</tr>
<tr>
<td>Corporate group</td>
<td>Limited market for interest</td>
</tr>
<tr>
<td>Large practice — general dentistry</td>
<td>Tough to keep revenue consistent; tough for younger owners to get out</td>
</tr>
<tr>
<td>Solo group</td>
<td>Buyouts are not mandatory, except in catastrophes; favorable taxation, except for family members in practices formed prior to August 10, 1993; underutilized practice form</td>
</tr>
<tr>
<td>Multiple locations</td>
<td>Founding owner, plus other new owners and separate entities — hopefully</td>
</tr>
</tbody>
</table>

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# Chart: Emerging Trends in Group Practice

<table>
<thead>
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<th>Type of Group Practice</th>
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<tbody>
<tr>
<td>Consultant and dentist — small corporate groups</td>
<td>The dentist is the custodian of the patient charts; risky</td>
</tr>
<tr>
<td>Specialists purchasing general practices</td>
<td>The goal is to increase referrals and earn a profit</td>
</tr>
<tr>
<td>Combinations of specialty and general practices</td>
<td>Easy to enter and very difficult to leave; retain your existing practice and combine future practices</td>
</tr>
<tr>
<td>Minority ownership — specialty or general practices</td>
<td>Better than associate pay; golden handcuffs</td>
</tr>
</tbody>
</table>
Questions?

William P. Prescott
Phone: 440/695-8067 • Fax: 440/695-8098 • Cell: 440/320-8984
Email: WPrescott@WickensLaw.com
Website: www.PrescottDentalLaw.com

Wickens Herzer Panza
35765 Chester Road
Avon, OH 44011
Pre-Liquidity Event
Estate Planning
Considerations

Emily A. Plocki
Optimize Timing

If addressed in a timely manner, pre-sale planning can leverage the business owner’s gift, estate, and generation-skipping transfer tax exemptions to shift significant wealth out of the taxable estate.

Planning Considerations:

• Seize opportunity to take advantage of valuation and discount opportunities in transferring wealth to members of the family
• Owner may wish to minimize income and capital gains taxes from liquidity event
• Sale may fund a charitable strategy and implement long-term philanthropic goals
Beware: How “Far Along” is the Transaction?

Assignment of Income Doctrine

• For Federal income tax purposes, when a sale of property is certain to occur and the seller gifts the property prior to closing, the seller risks being taxed on the sale, and is deemed to make a gift of the sale proceeds.

The analysis of whether the sale is certain at the time of the gift is a fact-driven analysis.

• Generally, if there are outstanding contingencies at the time of the gift, the gift is more likely to be respected for tax purposes.

However, if any of the following have occurred, a client may have progressed too far into the transaction:

1. Signed Letter of Intent (LOI);
2. Written Agreement; or

Pre-Transaction Planning: Specific Techniques

Direct transfer of business interests to family members or to trusts for their benefit.

“Leveraged” Transactions:
- Sales to Intentionally “Defective” Grantor Trusts (IDGTs)
- Grantor Retained Annuity Trusts (GRATs)
- Charitable Remainder Trusts (CRTs)
Technique #1: Gift of Company Interests

A simple yet effective strategy to pass part of the value of the business is to make a direct transfer of an interest in the business to a client’s family members or to trusts for their benefit.

Key Considerations:

• Recapitalize company into voting and non-voting interests.

• Ensure gift is made well before the business is on the market for sale, ideally at a time when the value of the business is still growing.
  • Any future appreciation above the value of the interests on the date of the gift is transferred out of the business owner’s estate.

• Recipient takes business owner’s basis in gifted business interests.

• Value of the gifted business interests may be eligible for substantial valuation discounts.
Technique #2: Sales to IDGTs

**Step 1**

Owner

Creates IDGT for the benefit of one or more family members

Gifts $ into IDGT to seed trust

**Step 2**

Owner

Sells all or a portion of company interest to the IDGT

IDGT issues a promissory note for FMV of company interest

**Step 3**

Owner

Portion of income generated used to service the annual payments of the promissory note

Intentionally Defective Grantor Trust

Company interest sold to IDGT generates income/dividends payable to the IDGT
Technique #3: Grantor Retained Annuity Trust

Owner transfers all or a portion of company interest to the GRAT. Owner receives an annuity for the term of years with company interest and/or cash.

Assets remaining after GRAT’s term ends are divided into Lifetime Trusts.
Technique #4: Charitable Remainder Trust

Owner transfers all or a portion of company interest to the CRT. The owner receives a fixed percentage either for life or a term of years with company interest and/or cash. Assets remaining at the end of the CRT term or owner's life (as applicable) go to charitable organization(s).
Qualified Opportunity Zones, Qualified Small Business Stock, Nongrantor Trusts and Incomplete Gift Nongrantor Trusts

Justin T. Miller
Qualified Opportunity Zones

QOZs, QOFs, QOZPs, QOZBs, QOZBPs

- § 1400Z-2 added by 2017 TCJA
- Investments in select economically-distressed communities eligible for preferential tax treatment
  - No “sin business,” such as massage parlor, hot tub facility, suntan facility, racetrack or other gambling, liquor store, golf course or country club
- HUGE tax benefits—§ 1031 exchange on steroids
  - Defer tax on any capital gains until earlier of sale/exchange or 12/31/2016
  - Special exclusion from original capital gains
    - 10% exclusion if held for more than 5 years
    - 15% exclusion if held for more than 7 years—i.e., investment in 2019
  - No capital gain on new investment if held for at least 10 years
- HUGE risk if bad investment—don’t let the tax tail wag the dog
Nongrantor Trusts

Potential Benefits

- Grantor not subject to federal income taxes on trust’s income
- Better asset protection—e.g., Delaware and Nevada
- Avoidance of state income taxation—e.g., 13.3% in California
- 20% deduction for qualified business income under § 199A
- $10,000 deduction for state and local income taxes under § 164(b)(6)
- $10,000,000 exclusion—or ten times basis, if greater—from capital gains for qualified small business stock under § 1202

1 But see section 643(f) (2010) and Treas. Reg. sections 1.199A-6(d)(3)(vii) (2019) and 1.643(f)-1 (2019) (anti-abuse rules to prevent taxpayers from establishing a non-grantor trust or contributing additional capital to an existing non-grantor trust with the principal purpose of avoiding federal income tax).
Incomplete Gift Nongrantor Trusts

DINGs, NINGS, and WINGs

• PLRs 201310002 – 201310006
• PLRs 201410001 – 201410010
• But see PLRs 201642019 and 201426014

Potential Benefits

• Accumulation of income free of state income taxes
• Asset protection

Potential Concerns

• Trusts in highest federal tax bracket at $12,750 (in 2019)
• “Throwback” rules
• Self-settled trusts subject to rights of creditors (i.e., grantor trusts)
• Might work, but might not
Disclosure

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