The tax-smart approach to buying and selling an orthodontic practice in this evolving landscape

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With the new norms in dentistry, more orthodontists than ever before are considering selling their practice to a Dental Support Organization (DSO) or to younger dentists interested in starting a practice of their own. These transactions often include a sale and purchase of the related dental office building. These new norms not only include the difficulties and opportunities presented by COVID, but also new challenges in practice management, with an increasingly complex tax code and other financial matters. We will be examining these issues from both the buyer's and seller's perspective and focusing our attention on the dental practice, as well as the dental office building transaction. (Semin Orthod 2022; 28:27–31) *© 2022 Published by Elsevier Inc.*

Introduction

The COVID-19 pandemic has caused orthodontists to face financial hardships, additional safety and regulatory requirements, and pressures to reevaluate how they treat patients and conduct business. As has been the case for countless dental practice owners across the country, many orthodontic practice owners have used this unique time to reevaluate their careers. For many, it forced them into retirement earlier than expected, others have left the profession because of safety concerns, and some have relocated from major cities to rural areas as they made quality of life choices for themselves and their families. For a large number of these orthodontists, this time has been a challenge, and for others it has been the beginning of a new adventure and opportunity. Even younger dentists have had to make similar career choices. This period has given them the opening to purchase an existing dental practice, start up a practice of their own, or to start working for a DSO.

As a Certified Public Accountant (CPA) and Certified Financial Planner™ (CFP®) who specializes in working with dentists across the country, I have recently come across a dramatic increase in the number of orthodontic clients seeking advice on retiring early, selling their practice, or relocating, and others interested in acquiring a practice for the first time.

Selling the orthodontic practice that you have worked so hard to establish or purchasing the practice you plan to spend the rest of your career with is never a simple process, since there are so many issues to consider. Aside from all the emotional and personal factors involved in determining if a practice sale or purchase is right for you, the sale itself carries with it a large number of financial, tax, and legal ramifications. This is why I recommend that you work with a CPA and CFP® who is well-versed in tax-smart strategies specifically for dentists. It is also critically important to work hand-in-hand with a dental practice lawyer who is an expert in dental practice acquisitions and sales.

When advising my clients on these topics, I always take a look at the big picture and assist them in structuring the transaction in the most tax-advantageous manner. Two key strategies that could potentially save an orthodontist hundreds of thousands of dollars in taxes are the proper treatment of goodwill in the practice transaction and the use of a 1031 exchange in the related dental office building transaction.

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Goodwill

In deciding how much your orthodontic practice is worth, 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 rate.

Goodwill is an intangible asset owned by either an orthodontic practice or its owner, which 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 orthodontist or the practice has the ownership rights to it. If you meet the requirements for personal goodwill treatment, this could result in significant tax savings to the seller.

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 individual federal capital gains, Medicare tax, and the applicable state and city tax rate). This is referred to as double taxation, since the gain on the sale would first be taxed at the corporate level, and then again at the individual level.

Having an employment contract that includes a non-compete clause between the owner orthodontist and their orthodontic practice could result in the goodwill being owned by the practice. For this reason, it is not recommended for an orthodontist 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 orthodontist who is selling the practice, this makes for a much stronger argument that personal goodwill exists.

An appropriate allocation of a portion of the sale price to personal goodwill can avoid the double taxation on a significant 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 the 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, which can still subject the practice sale to double taxation at the state and local level. Some of these jurisdictions include the District of Columbia, Louisiana, New Hampshire, New York City, Tennessee, and Texas. Since they do not recognize the Subchapter S corporate status, for the most part, they tax S corporations like C corporations.

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 $1,000,000 from the sale of goodwill could be subject to an additional $88,500 in NYC corporate tax.

Contract essentials

If there was no employment agreement with a non-compete, then the gain from the sale of goodwill could be taxed at the orthodontist's personal capital gain rate if structured correctly. It is important to note that, in addition to the corporate contract to sell the tangible assets (furniture, equipment, supplies, leasehold improvements) of the practice, there must also be a separate contract between the buyer and the orthodontist selling their personal goodwill (intangible asset), as well as a separate covenant not to compete. The proceeds from the sale of personal goodwill should be paid directly to the orthodontist (seller) and not to their orthodontic practice. I always recommend a separate contract, one for the tangible assets and one for the intangible assets, even if the practice is held through a flow-through entity.

Preparing for a tax audit

The IRS, as well as the state and local government, may scrutinize the claim of personal goodwill, so the orthodontist should follow these 6 steps to properly position themselves in the event of an audit.

(1) If the selling orthodontist 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.
(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. This would include the specific wording used in emails, contracts, and other written communications.
(3) When possible, an independent personal goodwill valuation 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.

Buyer's tax considerations

With regards to the buyer of the orthodontic practice, any amount of the purchase price allocated to furniture or equipment may also be subject to sales tax, depending on the state and local tax laws. Any amount allocated to goodwill is typically not subject to sales tax.

Generally, furniture and equipment can be fully written off under Section 179 or under bonus depreciation, although some states do not allow for bonus depreciation. This would allow the buyer to get a significant tax write off in the year of purchase. Otherwise, the standard depreciation on these tangible assets would allow you to write them off over 5–7 years. Goodwill, on the other hand, has to be amortized over a 15-year period. Buyers should use this information as leverage in negotiating their contract, especially since making an allocation to personal goodwill could result in significant tax savings to the seller. The buyer will need to weigh the pros and cons of how the asset values are allocated in the contract. I always recommend that they get a formal valuation in determining what dollar value should be allocated to each asset class.

1031 Exchanges and Delaware Statutory Trusts (DSTs)

Many orthodontists also own the office building that their practice operates from. This building could have been purchased decades ago, and the seller has little or no cost basis, since the property has been depreciated over the years. For this reason, some dentists choose not to sell the building, since the tax consequences of doing so could be significant when factoring in the capital gains, depreciation recapture, Medicare, and state and local taxes.

1031 Exchange strategy

Implementing a 1031 exchange tax-smart strategy is an extremely powerful tool when selling an orthodontic practice office building that will allow you to defer the tax liability and could potentially eliminate the tax entirely if the replacement property is held until death.

Section 1031 of the Internal Revenue Code provides an effective strategy for deferring capital gains tax that may arise from the sale of business or investment real estate property. By exchanging the real property for like-kind real estate, orthodontists may defer taxes and use the proceeds to purchase replacement business or investment real property. Like-kind real estate includes business and investment real property, which means your dental office real estate is eligible for this tax-smart strategy.

As an example, if you are planning to relocate to Florida from New York and start a new dental practice there, utilizing a 1031 exchange can assist you in avoiding these taxes. You could also take advantage of this strategy even if you plan on retiring fully, and instead you can replace the sale of your office real estate in New York with an investment property anywhere in the country.

In order to complete the 1031 exchange, in addition to hiring an attorney, you will also need to work with a qualified intermediary. The qualified intermediary is usually a bank or another attorney that facilitates the 1031 tax-deferred exchange. At the closing of the sale of your office building, all proceeds must be held in escrow by the qualified intermediary. The funds cannot be paid directly to you or your attorney, since this would disqualify you from completing a 1031 exchange.

Upon the sale and closing of your dental office building, you have 45 days to identify your replacement property. You also have 180 days from the date of your sale to acquire your replacement property. It is important that you work with an attorney and qualified intermediary who is familiar with these rules, since there are strict guidelines and regulations that must be followed.

Combining a 1031 exchange with a DST

Many orthodontists are simply too busy to manage their own investment property or have now decided they are going to fully retire and do not want the added responsibilities of property management. In these cases, combining a 1031 exchange with a Delaware Statutory Trust (DST) could be an excellent tax-smart strategy.

A DST permits fractional ownership where multiple investors can share ownership in a single property or a portfolio of properties, which qualifies as replacement property as part of an investor's 1031 exchange transaction. A DST takes all decision making out of the hands of investors and places it into the hands of an experienced sponsor-affiliated trustee.

As part of this strategy's major benefits, combining a 1031 exchange with a DST allows the orthodontist to eliminate the management responsibilities of property ownership, allows access to institutional-quality properties, provides limited personal liability protection, could provide both real estate asset class diversification and geographical diversification, and is also a powerful estate planning tool, especially when there are many beneficiaries involved.

Ultimately, a 1031 exchange used in conjunction with a DST can cause your tax deferral to become tax-free. Beneficiaries get a step-up in basis to the value as of your date of death, so you and your beneficiaries will permanently avoid the capital gains tax altogether. Tax deferral can legally become permanent tax avoidance.

Purchasing the dental office real estate

As the orthodontist purchasing a dental practice, you should also consider purchasing the office real estate as part of your transaction. Rather than paying rent to the landlord, you could pay this rent to yourself to help pay the mortgage placed on the property. In addition, you get the benefit of depreciation (phantom deduction) that will reduce the taxable income, even when you are generating a positive cash flow. Furthermore, over time, this real estate could appreciate in value, and when you are ready to retire, this could be another retirement plan to help supplement your income. Eventually when you're ready to sell, you too may be able to implement a 1031 exchange through a DST transaction.

Many orthodontists who are selling their practice may not be aware of this strategy, and this could be reason enough for them to sell their dental office building to you, so that both you and the seller could get the many tax benefits and increased cash flow that can come from this strategy. This could even give you the opportunity to further negotiate your purchase price when considering the significant tax savings to the seller. This is a win-win situation for both the buyer and the seller.

Conclusion

In these dynamic and changing times it is critically important that you work with an attorney, CPA, and financial planner who specializes in working with dentists and practice transitions, to ensure the sale or purchase of the orthodontic practice, as well as the dental office real estate, are structured correctly. Implementing these tax-smart strategies with major financial transactions is the only way to ensure you are minimizing your tax liability and keeping more of your hard-earned dollars.

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