

# Entity choice: Opportunities and traps

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**THIS IS THE SECOND** of a two-part article that considers entity choices and maintenance for practices and real estate entities. This second part deals with stock sales treated as asset sales, S corporation dividends, and the separate real estate entity. Find part one at [dentaleconomics.com](http://dentaleconomics.com). Search for "William P. Prescott."

## STOCK SALES TREATED AS ASSET SALES

To the extent that a practice has significant insurance and/or reduced fee plans where it is difficult for the purchasing entity to become credentialed with a new tax identification number, the purchasing entity can purchase the stock (retaining the selling practice entity's tax identification number) and be treated as a favorable asset sale under the Tax Code.<sup>1</sup>

In a complete purchase and sale, assets are sold and purchased. The seller's entity receives mostly favorable capital gains treatment because goodwill represents by far the

largest part of the sale. The purchaser's entity can write off all assets purchased—equipment more than three, five or seven-year periods, and goodwill more than 15 years. In addition, the purchasing entity does not purchase stock of the selling entity, so there is little, if any, successor liability.

## S CORPORATIONS AND DISTRIBUTIONS

Since 1998, a single-member limited liability company (LLC) can elect to be taxed as a disregarded entity or sole proprietorship, S corporation, or C corporation. CPAs

often believe that it is best for an owner to be treated as a sole proprietor until income reaches a threshold level above the Social Security wage base, which is \$132,900 in 2019. Thereafter, it becomes beneficial for the entity to be taxed as an S corporation in order for the owner to receive dividends that escape the Medicare tax. If the CPA elects for an LLC to be taxed as an S corporation and does not inform the practice's law firm, the law firm cannot prepare a corporate record book because, unlike an LLC, corporate formalities are required. Nor can it add provisions to the LLC's operating agreement that authorizes the entity to be taxed as an S corporation, which could jeopardize the S election.

There is an argument that if the LLC is taxed as an S corporation, a corporate record book should be prepared to maintain liability protection. However, there is also an argument that because the entity is an LLC for state law purposes, the entity is afforded the liability protection granted to LLCs in that particular state. Unfortunately, there is a cost to preparing the corporate record book that is well above the cost of amending an LLC's operating agreement to include S corporation provisions, whereby distributions must be in accordance with ownership percentages.

Be cautious about making large S corporation distributions versus salary as ordinary income, which does not escape the full payroll tax. Some advisors advocate paying the practice owner a "reasonable" salary equal to what an associate dentist would earn versus what a practice owner would earn. I suggest that the analysis should be the compensation that of a similarly situated practice owner, versus what an associate dentist, would earn.



Be cautious of taking a relatively high income as an LLC owner, then electing S corporation status and taking large distributions lower than the historical compensation earned. For example, if a single-member LLC owner has historically earned \$200,000 of compensation per year, then elects to be taxed as an S corporation and claims \$100,000 of compensation and \$100,000 as a dividend, this is problematic. The IRS has said that it will win the unreasonable compensation cases that it chooses to pursue.<sup>2</sup>

### THE REAL ESTATE ENTITY

The real estate should be owned in an entity other than the practice entity for both taxation and timing of practice sale purposes. The practice should have a written lease with the real estate entity to which rent and occupancy costs are paid. Owning the real estate in an LLC is the preferred entity, so that “basis” includes any debt or unpaid mortgage when the real estate is sold.

For example, the owner’s contribution is \$60,000 or 20% of the cost to purchase

the real estate. The cost of the real estate is \$300,000, \$224,000 of which is a loan. When the real estate is sold, the basis is \$300,000, above which capital gains are paid, not the \$60,000 plus the sum of the loan payments made. This is not the case in an S or C corporation. However, if the real estate is currently owned in an S or C corporation, the CPA should be authorized to complete a tax analysis as to whether to convert the real estate ownership to an LLC, which may cause a taxable event.

### SUMMARY AND THOUGHTS

Where there exists more than a few insurance or reduced fee plans, and where credentialing is anticipated to be difficult and time consuming, a stock sale treated as a favorable asset sale may be appropriate.

Be careful of large S corporation dividends to minimize taxation where taxable income was previously at higher levels before an S election was made, or where income versus dividends was lower than a similarly situated dentist or associate dentist.

Finally, own the real estate in a separate LLC, both for liability protection and tax purposes to include basis of any unpaid mortgage. **DE**

### REFERENCES

1. Internal Revenue Code, Section 338(h)(10).
2. Williams B, Cook J, Longman RA, Prescott WP. Worker Classification—The IRS, the DOL, and the State of California. Panel presented at American Bar Association meeting, Section of Taxation, February 9, 2018.



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