Newsletter Article Reprint

The Three Prong Approach: Important IRS Considerations for Structuring a Partnership

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An increasingly common method of structuring partnerships for the incoming owner is to form an S-Corporation and purchase assets from the existing practice owner. Thereafter, the new and existing owners operate the practice through a newly-formed limited liability company or partnership that collects the revenues, pays the operating expenses and employs the staff. Profits fall to the entities owned by the respective owners. Each doctorowned entity pays the business expenses of each owner that may include liability insurance, continuing education, business travel, possibly lab and other expenses which may be disproportionate between the owners. General operating, staff, and occupancy expenses are usually split 50/50 in a two doctor practice. While this approach has benefits of potential deductibility/amortization of assets for many incoming owners and primarily capital gains treatment for the existing owner, there are two relatively unknown traps.

For those practices that were formed pre 1993, the Internal Revenue Code ("IRC") Section 197, anti-churning rules, will deny amortization of the goodwill purchased for the buy-in for the first half of the practice by the incoming owner if the existing and new owners have at least twenty percent (20%) ownership. It is the third entity, the limited liability company or partnership, that creates this problem.

If, on the other hand, the owners operate with separate practices under a solo group arrangement, with no common ownership of a third entity, the goodwill is amortizable for the buy-in.What's more, under IRC 414(m), each separate practice may adopt its own tax-qualified retirement plan without covering the employees of both practices. This is a good thing and shared employees can be accounted for.

IRC Section 197 does not provide for bifurcation of the goodwill from pre and post 1993. This is probably not the result intended by Congress in enacting this legislation, but is, in the view of some commentators, the result. This trap can be avoided by forming a solo group, becoming"partners" in an entity which has other ramifications or remaining a solo practitioner – probably the best route.

The second problem relates to S-Corporation distributions, which have the effect of eliminating the 2.9% Medicare tax. First, it is no secret that the IRS dislikes S-Corporation distributions and believes that this practice is being abused. Second, where the three tier approach is used and the initial entity is a limited liability company, there is authority that the S-Corporation distributions are unavailable and that all income flowing through the limited liability company is self-employment income, irrespective of the "reasonableness" of the S-Corporation distributions.

While this three tier approach is relatively popular, these traps exist, but can be avoided by the formation of a solo group or partnership without a third entity. Nevertheless, the first problem is avoided if the entity was formed post 1993.

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