Practice Transitions and Taxes

Taxes are a fact of life, and an extremely important consideration when considering a dental practice transition or sale. Let's explore some potential tax mitigation strategies to consider.

Stock Sale. If you are incorporated, sale of the stock in your corporation to the dental practice buyer can potentially yield you the greatest tax savings, because the sale of stock is almost exclusively taxed at the lower fixed capital gains rate as compared to the higher, tiered ordinary income rates. However, and this is a BIG however, stock is a non-depreciable asset to the buyer. As such, the dental practice buyer is not able to write off the sales price and essentially ends up buying your practice with after-tax dollars. Consequently, a buyer is likely only to agree to buy your stock if you are willing to reduce your purchase price by 30 percent or more. For this reason (and many associated legal and liability complications), almost all dental practices are sold as "asset sales." In other words, the seller retains his/her corporation and all of its stock and instead sells all of the tangible and intangible assets of the corporation (i.e., the dental practice). The buyer is then able to depreciate and amortize (write off) the entire purchase price.

Price Allocation. The IRS requires the total price of a dental practice for sale to be allocated to the various types of assets being sold and that the allocation be made according to the fair market value of the assets. As a general rule, the tangible assets are taxed as ordinary income above basis, and the intangible assets are taxed as capital gains. (Above basis means the difference between what you are selling the tangible assets for and your book value or depreciated value.) Any consideration for a covenant not to compete will also be taxed as ordinary income. Since fair market value is somewhat subjective, there is some room for negotiating the overall allocation of the purchase price. As a dental practice seller, you will save taxes if you can negotiate with a buyer for a lower allocation to tangible assets (equipment, furniture, fixtures, supplies, etc.) and a higher allocation to intangible assets (goodwill and patient records). (Unfortunately, it will benefit the dental practice buyer to have just the opposite allocation, so consideration must be given to making the allocation fair to both parties.)

Carry back a note. Sellers frequently ask us, "Won't I save on taxes if I self-finance part or all of the sales price (i.e., carry back a promissory note from the buyer)?" The answer is, "No, but maybe . . ." As mentioned above, the portion of the price in an asset sale that will be taxed as ordinary income will be due in the year of the sale. That recapture will be taxed regardless of the receipt of any actual cash at closing, which means you owe the ordinary income tax associated with the recapture even if you do not receive a cent at closing. Consequently, if you do not want to have to pay to sell your practice, it would be prudent to ask for enough of a cash down payment to cover the tax liability you will incur from the recapture. Since most of the remainder of the sales price will be taxed as capital gains and since the capital gain tax rate is a fixed rate, the same tax will be applied and the same tax amount owed whether you receive that portion of the price now or paid to you over time; unless . . . there is a change in the capital gains tax rate before the note you are carrying is paid off. If the rates go up, you would be taxed at that higher rate on that income as it comes in. Otherwise, self-financing a portion of the price serves only to defer capital gains tax, but it will not lower the total tax. (Also note that the interest portion of any promissory note payments will be taxed as ordinary income to the holder, while the principal portion subject to capital gains will be taxed at the capital gains rate.)

Sale Timing. As discussed above, the tax associated with recapture over basis on the sale of tangible assets will be determined by your ordinary income tax bracket in the year of the sale. If you are planning to retire after the sale of your practice and, consequently, will have a drop in your ordinary income level, it may behoove you to strategically time the sale of your practice until after the start of the next tax year. Also, if you have owned your dental practice for less than one year, you should, if possible, wait at least one full year before selling it since the sale of goodwill within a year of ownership will result in the higher short-term capital gains rate being applied instead of the long-term capital gains rate.

"C" Corporation Consideration. If you are currently incorporated and being taxed as a regular "C" Corporation, the sale of goodwill by your corporation will likely be subject to double taxation once as capital gains inside your corporation and then again as ordinary income when paid as a distribution to the shareholder(s). There is some case precedence that allows for the shareholder(s) of "C" Corporations in closely held and professional businesses to sell goodwill individually, outside of the corporation, thus avoiding that double taxation. If this applies to you, consult with your CPA and/or tax attorney regarding the details of such a tax strategy and its application to your particular situation.