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## HEALTH CARE LAW

### Entity Selection for Health Care Professionals

A health care professional establishing a practice faces multiple tax considerations

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**N**o decision has a greater impact on a health care professional's tax liability than the selection of the business entity under which he practices. A health care professional may practice as a sole proprietor or as an owner of a partnership, limited liability company or professional service corporation.

When a health care professional embarks upon the journey of professional practice, tax considerations come into play at every stage — formation, operation, the addition of new owners to the entity, the transfer of property, borrowing money and, eventually, owner withdrawal or termination of the business. In addition to the

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relevant tax considerations, the owner must discern which entity form addresses and accommodates the business and economic arrangement of the owner and/or employees, the desired capital structure, and relevant management considerations.

The first important consideration is formation and capital contributions. Forming an entity under state law does not determine how it will be classified for federal and state tax purposes. Specifically, an owner will form a corporation, partnership (either general, limited or limited liability partnership) or a limited liability company (LLC) pursuant to state law. However, the forms of tax treatment contemplated by the Internal Revenue Code of 1986, as amended (IRC), and the relevant tax principles associated with each form of tax treatment can vary greatly when applied to the same circumstances, thus resulting in vastly different tax consequences.

The "Check-the-Box" regulations issued pursuant to IRC § 7701 allow an entity that is not a corporation to choose its federal tax treatment. If such entity fails to make a valid election, the default rules apply. Under the default rules, an entity with at least two members is treated as a partnership and an entity with one owner is disregarded as a separate entity. Otherwise, an entity may elect to be treat-

ed as a corporation. Similarly, a corporation can elect to be taxed pursuant to Subchapter S of the IRC (S corporation) by filing a Federal Form 2553, or make no election and be taxed pursuant to Subchapter C of the IRC (C corporation). Unlike a C corporation, the S corporation provides the benefit of a single level of tax at the shareholder level, similar to partnership tax treatment; however, rigid ownership and distribution rules limit the ability of some business models to utilize the S corporation option.

Capital contributions are treated differently with respect to corporations and partnerships. In the corporate setting, pursuant to IRC § 351, gain or loss is not recognized upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in the corporation, if immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. Control is defined as possessing: (i) at least 80 percent of the total combined voting power of all classes of stock entitled to vote; and (ii) at least 80 percent of the total number of shares of all other classes of stock of such corporation. Failure to meet both of the foregoing tenets will result in a taxable transaction for the unwary. Stock that may

be received tax-free in an IRC § 351 exchange does not include stock rights or warrants or certain debt-like preferred stock, including preferred stock that the corporation must redeem. Treas. Reg. § 1.351-1.

The control requirement will generally be satisfied at the time the corporation is organized to do business. Contributions made by a single or small percentage of the existing shareholders after formation of the corporation, however, may not qualify for the tax-free contribution treatment, unless the shareholder(s) satisfies the ongoing control requirement. If the control requirement is not met, the contributing shareholder will be liable for the tax on the amount by which the value of the stock received for the contribution made exceeds his adjusted basis in the property contributed. Conversely, if the contributing shareholder recognized gain on the transfer, the corporation would reap an immediate benefit because it will take the contributed property with a basis equal to the property's fair market value for depreciation purposes. IRC § 1012. If the value of contributed property exceeds the value of the stock received in exchange for such property, and the transferors receive cash or other property in addition to the stock (known as "boot"), their gain on the appreciated property transferred to the corporation is taxable to them to the extent of the boot received. IRC § 351(b).

By contrast, partnership tax rules governing formation and capital contributions are more flexible and forgiving. No gain or loss is recognized, either to the partnership or to any of its partners, upon a contribution of property to the partnership in exchange for a partnership interest. This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership already operating. Treas. Reg. § 1.721-1. A partner contributing appreciated property to the partnership may lose tax-free treatment if he receives a related distribution of cash or property from the partnership, if the partnership distributes the property he contributed within seven years to another partner, or if the partnership distributes other property to him within seven years. §

704(c)(1)(B).

Basis is another important consideration when choosing an entity. A shareholder's basis in his corporate stock is his cost for such stock, IRC § 1012, subject to adjustment for depreciation. IRC § 1016(a). If property is contributed to the corporation in exchange for stock in a transaction which qualifies as a nontaxable IRC § 351 transaction, the basis of the stock received will be equal to the basis of the property contributed to the corporation, increased by any gain recognized and decreased by any liabilities assumed by the corporation (up to the basis of the property contributed). IRC § 358. The corporation's basis in property received pursuant to an IRC § 351 transaction is equal to the transferor's basis in such property before the transfer, increased by the amount of any gain recognized by the transferor. IRC § 362.

When capitalizing a new business, shareholders and partners alike contribute certain assets with inherent gain or loss. When a partner contributes such assets to a partnership, the precontribution gain or loss inherent in the property is allocated to the contributing partner to the extent realized by the partnership upon disposition. IRC § 704(c)(1)(A). This result ensures that the partner who possessed the appreciated or depreciated property receives the benefits or disadvantages associated with the property in question.

Importantly, corporate tax rules do not contain a similar analog. In an S corporation setting, a tax-free contribution and subsequent disposition of property with a built-in gain or loss will result in the allocation of the respective gain or loss to the shareholders in proportion to their stock interests. IRC § 1366(a). Hence, a shareholder contributing appreciated or depreciated property may, in effect, shift a portion of the precontribution gain or loss to the other shareholders. Alternatively, those shareholders who contributed money to the corporation are disadvantaged because they will have an obligation to recognize income upon the disposition of those appreciated assets.

A partner's basis in his partnership interest (known as "outside basis") is the

amount of cash and/or the adjusted basis of any property contributed by the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under IRC § 721(b). IRC § 722. If the contributed property is subject to indebtedness or if liabilities of the partner are assumed by the partnership, then the basis of the contributing partner's interest is reduced by the portion of the indebtedness assumed by the other partners. Treas. Reg. § 1.722-1. Adjustments in a partner's share of liabilities of a partnership, and in a partner's individual liabilities, will result in corresponding adjustments of a partner's basis in his partnership interest.

Partnership tax treatment at times best effectuates the economic arrangement of the owners, which is perhaps most readily apparent upon the entrance of a new partner to an existing partnership. In such a case, a disparity may exist between the basis the partnership has in its property, (known as "inside basis"), which may have substantially depreciated, and the new partner's outside basis in the partnership interest.

A partner buying into a partnership takes a cost basis in the partnership interest purchased. If the partnership does not have an IRC § 754 election in effect at the time of the purchase, no adjustment will be made to the basis of the partnership's property. IRC § 743(a). The disparity between inside basis and a purchaser's outside basis can be detrimental to the purchaser upon the partnership's disposition of partnership property that has significantly depreciated.

To remedy this distortion and modify a new partner's share of the partnership's adjusted basis in its assets, under IRC § 754, a partnership may make an election to: (i) increase the adjusted basis of the partnership property by the excess of the basis of the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property; or (ii) decrease the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis

of his interest in the partnership. IRC § 743(b).

Another important distinction between corporations and partnerships concerns financing. Specifically, any increase in the partnership's liabilities is in effect treated as if it were a cash contribution made by each partner to the partnership, and thus, increases the partner's basis. IRC § 752(a). Accordingly, each partner's percentage interest in the partnership's debt increases the basis each partner has in his partnership interest, which allows each partner to deduct his share of partnership losses to the extent of his basis in the partnership. IRC §§ 722; 705(a); 704(d). Conversely, debt obtained by a corporation does not affect a shareholder's basis in his stock interests. IRC § 1367(a).

The distribution of cash flow engenders a number of different issues based on the type of entity. The dissemination of business income in a corporation can occur in one of two ways: compensation and dividends. Typically, C corporations will distribute all available cash flow in the form of compensation. These compensation amounts ordinarily are deductible, assuming that they do not constitute unreasonable compensation. If the IRS determines that a portion of the compensation paid to a shareholder-employee is unreasonable, the corporation may have to reclassify a portion of the compensation amounts paid as a nondeductible dividend distribution, IRC § 301, 316(a), resulting in a corporate and possibly shareholder level tax to the extent of the corporation's earnings and profits. IRC §§ 61(a)(7), 301(c)(1). If the distribution exceeds earnings and profits, it is first treated as a nontaxable return of capital that reduces the shareholder's basis in his stock, with any excess over basis treated as capital gain. Therefore, if the business becomes extremely profitable, the shareholders may have to reconsider their entity form if the compensation amounts paid are subject to reclassification.

Partners have significant flexibility in allocating the partnership's income and losses and making distributions among the partners. The partnership agreement may specifically allocate certain items of income or deduction in different proportions among the partners, provide for preferred returns, allocate income disproportionately to the partners' capital contributions, or change allocations midstream. Those allocations will be respected for tax purposes provided they have "substantial economic effect" in that they affect the dollar amount the partners realize from the partnership exclusive of tax consequences. Treas. Reg. 1.704-1(b)(2). Although S corporations provide for a single level of tax similar to a partnership, the stringent S corporation distribution rules preclude shareholders from distributing available cash flow in the same manner as a partnership.

The type of business entity can impact upon the withdrawal of an owner and the termination of the business. On the sale or exchange of shares of a corporation, the selling shareholder's gain or loss is equal to the excess of the amount realized from the transaction over the adjusted basis in the transferred shares. A selling shareholder's amount realized from a taxable sale of the shares includes the amount of cash plus the fair market value of any other property received in exchange for the shares. IRC § 1001.

On the sale or exchange of a partnership interest, the selling partner's gain or loss is equal to the excess of the amount realized from the transaction over the adjusted basis in the transferred partnership interest. Pursuant to IRC § 741, a selling partner's gain or loss recognized on a sale or exchange of the partnership interest is generally considered as gain or loss from the sale or exchange of a capital asset. However, ordinary income is recognized on the sale or exchange of the interest to the extent of the selling partner's allocable interest in the partnership's unrealized receivables and inventory. IRC § 751(a). Thus, a partner may

realize some ordinary income upon a redemption, whereas a corporate shareholder would not experience a similar drawback.

Conversely, the partnership would be able to deduct as an expense those payments to a redeemed partner attributable to unrealized receivables and substantially appreciated inventory, whereas a corporation would not experience such a benefit. The IRS generally will respect the agreed value of an exiting partner's interest in partnership property (including goodwill) if it is determined pursuant to an arm's-length agreement between the exiting partner and the remaining partners. Treas. Reg. § 1.736-1(b)(1).

Use of the partnership model may not be advantageous if the owners contemplate using the partnership to consolidate or merge with another business on a tax-free basis, unless the entity is classified as an association taxable as a corporation. Certain corporate actions, such as a statutory merger, consolidation or recapitalization, will be treated as a tax-free reorganization under IRC § 368(b). Presently, the partnership tax provisions only allow entities qualifying for partnership tax treatment to merge with other partnerships or divide into two or more partnerships, but do not contemplate the types of tax-free reorganizations only available to corporations. See IRC §§ 708(b)(2)(A), 708(b)(2)(B), 368(b).

A health care professional should select the type of entity that is most compatible with his practice's needs. While other issues such as business strategy and exposure to liability should also be considered, the tax consequences of which type of entity a practitioner selects for his practice may have the greatest impact on the viability of the practice. No health care professional should commence the process of forming a practice without competent legal, business and financial advice from professionals experienced in the health care and tax arena. ■