Careful Planning

Can Minimize Tax Consequences of Imaging Center Sales

BY JOHN P. HOLMAN AND THOMAS W. GREESON

Over the past several years, we have worked with an increasing number of clients who have been considering whether to restructure or sell their interest in their free-standing imaging centers. Partly driven by decreased reimbursement for free-standing imaging service and partly driven by hospital interest in acquiring centers, we have recently worked with groups who have sold their ownership interests in imaging centers to the hospital where they practice.

The sale of an imaging center's assets may generate significant gain, and the tax consequences will depend on how the center's assets are held. This article outlines various ownership alternatives and suggests what can be done to mitigate a less than optimum ownership arrangement.

Ownership Alternatives

C Corporations (including PCs, PSCs, PAs, and non-professional "regular" corporations) file federal Corporation Income Tax Returns (IRS Forms 1120) and pay corporate-level tax on their net taxable income. Such entities must report income from the sale of imaging center assets, often resulting in significant entity-level income tax. Upon the distribution of the net sale proceeds, the shareholders are subject to a second tax, either as a dividend if in a non-liquidating distribution, or as capital gain if in connection with the liquidation of the entity. C Corporation ownership typically results in the highest total income tax bill.

LLCs and **Partnerships** typically file federal Returns of Partnership Income (IRS Forms 1065), and are treated as "pass-through" entities that are not subject to entity-level income tax. Rather, the gain from the sale of their assets is reflected on K-1s they issue to their owners, causing the net income to instead be reported on the owners' individual income tax returns. This arrangement generally results in the lowest total income tax bill.

S Corporations file federal Income Tax Returns for S Corporations (IRS Forms 1120-S). With important exceptions, income derived from the sale of an imaging center owned by an S Corporation is reflected on K-1s issued to the entity's owners, causing it to be reported on the owners' individual income tax returns. If the entity has had S status during the entire period of its imaging center investment, or if the entity has had S status for 10 years or longer since acquiring its interest in the imaging center, the tax results are usually comparable to that for LLC or Partnership ownership. However, if the entity converted to S status from earlier C Corporation status and has not had S status for at least 10 years prior to the sale, gain attributable to an increase in value of assets prior to converting to S status is subject to entity-level C Corporation income taxation. In that case, the tax results are similar to that of a C Corporation on the portion of the gain that is attributable to the value of its

interest in the imaging center assets as of the date of its conversion to S status, and similar to that of an S Corporation on the remaining portion of the gain.

Planning Suggestions

New Imaging Center Investment. In recent years, most imaging centers have been formed as LLCs. This structure not only provides a liability shield, but also offers flexibility on matters such as voting, management, division of profits, buy-ins / buy-outs, and internal asset basis step-ups for new owners. It also provides the favorable pass-through / one-level of income tax treatment mentioned above.

Existing C Corporation Imaging Center Investment. If imaging center assets were previously acquired in a C Corporation, the shareholders may want to convert the ownership to another arrangement. Unfortunately, if C Corporation shareholders form a new LLC and the C Corporation sells its imaging center assets to that entity, the C Corporation tax treatment outlined above applies—most likely triggering significant current entity-level income tax and shareholder-level income tax. The result would be the same if a C Corporation simply converts to LLC status, or if it distributes its appreciated imaging center assets to its shareholders and they, in turn, contribute the assets to a new LLC, or if the C Corporation makes a direct transfer of the assets to the new LLC.

A common planning technique is for C Corporation shareholders to cause the entity to convert to S Corporation status. This works well if the disposition occurs 10 years or more after converting to S status, allowing entity-level tax on the sale to be avoided. An S election may also result in lower taxes, even if the assets are sold prior to the end of the 10-year period, because while corporate-level tax is imposed in the year the sale occurs, it is imposed only on the amount of the gain attributable to appreciation of assets measured as of the date of the conversion to S status and asset appreciation that occurs after converting to S status is not subject to corporate-level income tax—provided the owners can prove the value as of the time of the conversion to S status. Accordingly, an appraisal of the entity's assets as of the date of the conversion is critical. It should also be noted that a post-S conversion sale, disposition or collection of the entity's other appreciated assets, prior to conversion to S status (such as collection of accounts receivable) may result in entity-level tax, so careful analysis by a tax professional before proceeding is important.

Goodwill and Going Concern Value. The worth of an imaging center business includes not only the value of imaging equipment (such as MRI, CT, PET, X-Ray, and other specialized equipment) and other tangible assets (such as office equipment and furnishings) and accounts receivable associated with the center, but also includes amounts attributable to the center's goodwill / going concern value (such as the customer list, workforce in place, good reputation, brand name, and other intangibles affecting earnings). The tangible assets and accounts receivable are almost always owned by the imaging center entity. The goodwill / going concern value of the business is also commonly owned by the imaging center entity or, perhaps worse, by the related professional service entity; however, with careful planning there may be an opportunity to keep that ownership out of those entities and improve the tax results.

As a rule, medical groups want to prevent their owners from engaging in competitive activities, soliciting clients, and recruiting employees, both during and after their employment with the professional service entity, and the vast majority of professional employment contracts contain noncompete agreements running in favor of the entity. Unfortunately, this can cause a tax problem upon the sale of assets owned by the entity if goodwill is a part of the assets being sold. This is because the IRS takes the position that where physician-owner employment contracts contain a noncompete provision, the physician-owners are prohibited from engaging in a competitive practice or owning competitive imaging center assets; they are precluded from personally owning goodwill, so all goodwill must instead belong to the professional service entity.

This is troublesome tax-wise because a buyer almost always requires the selling entity, the related professional service entity, and/or each of their physician-owners to enter into noncompetition agreements in connection with the sale. If the goodwill is owned by a C Corporation, double-taxation on the value associated with such goodwill is typically the result.

How Groups Can Mitigate Tax Exposure

— First, a group may consider forgoing noncompete agreements in its shareholder-employee contracts. (We realize the downside of this alternative.) Absent noncompete agreements, the owners are not precluded from forming a competing entity, owning other imaging centers, or engaging in activities that compete with the imaging center or the professional service entity, so any goodwill would not be owned by the corporation but would instead be owned by the shareholders. This would mean that sales proceeds can be paid directly to the shareholder and taxed as capital gains (if paid for personal goodwill) or as ordinary income (if paid for a personal noncompete covenant), each a better result than double taxation. While this arrangement may be a viable option for a single owner, we recognize that radiology groups are likely to find it unattractive to risk allowing professional service entity owners to engage in competitive activities.

— Second, as an alternative to the first option, a group may choose not to have the professional service entity enter into noncompete agreements with its shareholders, but to seek instead to protect against the threat of competitive activities by having the shareholders enter into noncompete agreements among themselves, with the entity not being a party to those agreements. In that scenario, it would seem that the goodwill would not be a corporate-owned asset, but would instead be an asset that is owned by the shareholders. Under that arrangement, the portion of the sales proceeds that is attributable to goodwill should be taxed only to the shareholders.

— Third, the C Corporation may attempt to mitigate its entity-level tax exposure by using part of the sales proceeds to pay additional compensation to its shareholder physicians, thus creating deductions that may offset the entity-level income. Careful planning, including both justification and documentation, is essential to address an argument that the payment is "unreasonable" if the IRS attempts to recharacterize the payment as a "disguised dividend" and to deny the deduction.

— Fourth, the physician-owned entity that owns the imaging center may elect S status. If done long before the sale, this may allow the owners to avoid all or most of the corporate-level tax as outlined above.

While taxation following the sale of imaging center assets may not be completely avoided, careful planning may prove helpful in mitigating the tax consequences of the transaction.

** This article does not constitute legal advice. Radiology groups are advised to consult with their own lawyer for such counsel.*

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