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Double Taxation Is Not Nice

Can your practice corporation take a tax deduction for the full amount of the salaries it pays its shareholders? A Tax Court case from a few years ago (*Pediatric Surgical Associates, PC v. Commissioner of Internal Revenue*) makes it uncertain whether a professional corporation, which is a "C" corporation for federal income tax purposes, can legally deduct the full amount of the salaries it pays its shareholders.

In the case, the Tax Court found that a portion of the compensation paid to the shareholders of a professional corporation ("PC") was not deductible as compensation, but was actually real "profit" that the PC should have paid to its shareholders as dividends.

Tax Background

The reason why this case is troublesome is because the practice in the Tax Court case was a PC organized as a C corporation with both shareholder and non-shareholder doctor-employees as are many dental practices.

This is important because:

- C corporations are separate taxable entities
- C corporations can deduct compensation paid to employees, whether they are shareholders or not, only if the compensation paid is reasonable and is paid "purely" for the personal services the employee rendered
- C corporations cannot deduct dividends paid
- C corporations that are PCs pay federal income tax at a 35% rate on all of their taxable income
- A PC's shareholder-doctors must still pay income tax on the full amount the PC pays them even if it is a dividend instead of compensation
- A dividend results in classic double taxation (i.e. the PC pays income tax and shareholder-doctors pay income tax on the same income)
- Double taxation results in a possible effective tax rate over 70%.

The Case

The PC in the Tax Court case did what most PCs do. After satisfying all operating expenses, the PC paid most of its remaining cash to its shareholder-doctors as monthly and year-end bonuses. In fact, this PC actually was unlike most PCs in that it filed its federal corporate income tax return showing a more than nominal taxable income in each of the two years in question. The bonuses the PC paid to its shareholder-doctors included the so-called "profit" the PC made on its non-owner doctors (that is, the difference between what the associate doctors generated in revenue and the sum of what they were paid plus an allocable share of operating expenses).

Such bonus compensation C corporations pay to employees, whether they are shareholders or not, is a fully deductible expense for C corporations, provided that the compensation is reasonable and is paid "purely" for the personal services rendered.

The IRS disagreed with the PC's deduction of the bonuses it paid to its shareholder-doctors, arguing that, to the extent the bonuses represented the "profit" generated by the non-shareholder doctor-employees, the bonus payments to the shareholder-doctors were actually distributions of corporate "profit", and therefore properly payable as dividends. Remember that a C corporation cannot deduct dividends. Consequently, the PC had additional taxable income upon which it owed federal corporate

income taxes while the shareholder-doctors still paid income taxes on the bonuses they received (i.e. double taxation).

The PC appealed the IRS's decision but the Tax Court agreed with the IRS reasoning that the PC did not show that the bonuses were deductible compensation. The court focused on the concept that the PC did not pay the bonuses to the shareholder-doctors "purely" for services the shareholder-doctors rendered, so the bonuses were not legally deductible compensation.

Since many dental practice PCs are set up as C corporations with shareholder and non-shareholder doctor-employees, this case is pertinent and raises some concerns. It does not necessarily mean that PCs have to begin declaring corporate dividends to the extent associate doctors generate more revenue than they are paid. It does mean, however, that C corporation PCs need to consider how best to handle this potential problem going forward.

Prevention

It appears that the PC in the Tax Court probably could have done more to justify the bonus compensation it paid to its shareholder-doctors. All in all, it seems that much of the problem came down to the PCs lackadaisical approach to bonus and year-end planning. Perhaps there was a simple failure in the corporate year-end process to accurately document and reflect the amount of significant non-production benefits and services the shareholder-doctors provided the PC during the year. You want to do all you can to avoid a problem like this for your PC in the future.

First, you need to consider and document all the work that the shareholders do to assist the non-shareholder employees. A PC's shareholders are all active to some extent in training and supervising the associates. Furthermore, nurturing, mentoring, and developing associates are crucial to making them effective, but may reduce a shareholder's actual personal income production.

Second, shareholders render significant management services in running the business of the dental practice and supervising its managers. The shareholders generally share responsibilities for running the practice to some extent. These activities go beyond just each doctor's own production. They all assist in recruiting, compliance activities, personnel reviews and the like. They are also likely closely involved in planning, negotiating with HMO's, supervising various personnel, and so on. These are all valuable services worthy of compensation.

Third, you should include reference to all of those shareholder services in corporate minutes every time your PC pays additional compensation to its shareholders, whether the payments represent interim or year-end bonuses.

Other Areas for Concern

The issue of the deductibility of compensation a PC pays to its shareholder-doctors can also arise with employees other than associate doctors or if your PC performs ancillary services that have technical components or facility fees that generate significant revenue beyond their true full costs. For example:

- Technical component of diagnostic equipment (e.g. imaging, lab, lasers and scanning equipment)
- Drug mark-ups
- Ambulatory Surgery Centers
- Doctor extenders (e.g. Dental Assistants, Dental Hygienists, Nurse Practitioners, etc.) - especially if you employ a number of them

Consider Changing Your Current Compensation Plan

Make sure the compensation your PC pays to its shareholder-doctors is documented to include all of the personal services they render. In all of the examples above, significant time, energy and human expertise must be devoted to generate "profit." Does the PC's compensation plan reflect that time?

Those services likely do include many non-monetary benefits, such as supervision, management and the like.

Consider Changing Your Practice Tax Status

Another option available is to restructure your PC into a "pass through" entity. These include "S" corporations, limited liability companies (LLCs) and limited liability partnerships (LLPs). These "pass through" types of entities do not usually pay any tax at the entity level. Rather, the entity's "profit" (and associated tax liabilities) are "passed through" to the owners and handled on their personal income tax returns. A "pass through" entity eliminates the double tax problem.

Whether this is a good option is very practice-specific. The negatives may easily outweigh the benefits. It is best to consult your practice accountant, tax advisor and attorney before making any drastic changes.

Consider Paying a Dividend

If you have one or more of the possible problem areas mentioned above and none of the other proposed solutions eliminate the problem, consider having your PC pay at least some of the "profit" from such activities to the shareholders as a dividend. It would mean paying some corporate tax (i.e. pay some double tax), but it may not have to be a large amount. At a minimum, discuss this possibility with your practice accountant, tax advisor and attorney.

Conclusion

The Pediatric Surgical Associates case should cause all C corporation PCs to question whether or not all of the compensation the PC pays to its shareholder-doctors is in fact paid "purely" for the personal services the shareholder-doctors rendered or is instead a disguised distribution of corporate "profit."

As the Tax Court said, this is a factual question to be decided on the basis of the particular facts and circumstances of the case. If you do nothing else, you should document the facts in your PC to your best advantage to help avoid the Pediatric Surgical Associates case double tax problem. Keep your compensation plan in mind and don't forget your approach to bonus planning and year-end meetings, as they are ideal places for proper tax planning.

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