Tax Ramifications of Sweat Equity in Professional Partnerships

By Robert W. Olson, Jr.

Many professional practice owners would prefer to sell their practices over time in order to maintain their income and control for an extended period. Additionally, many associates want to be assured of an increasing share of practice ownership in exchange for their loyalty to the practice. These two goals are met in "sweat equity," the gradual transfer of the practice from owner to associate leading to 50/50 partnership and/or owner retirement. The various legal approaches to sweat equity have widely different tax ramifications, and close analysis reveals a single approach that works for the owner and the associate. Notably, owners who choose *not* to report a sweat equity transaction to the IRS actually pay far *more* in taxes than those who *do* report it!

Introduction

Professional practice transitions are seeing a shift in the way practices are transferred to the next generation. Lending standards are stricter so it is more difficult for buyers to qualify for full practice purchases. Sellers have found that their price expectations are not being met, and in combination with retirement fund losses, they can no longer afford to completely leave the practice. The solution to these problems, for both buyers and sellers, has been the professional partnership.

There are many issues that need to be addressed prior to entering into any partnership: personal compatibility, employee loyalty, operational standards, contractual and legal issues, and practice valuation all are significant matters that need to be addressed and, resolved. For the purpose of partnership dynamics and longevity, a 50/50 partnership is always best. When the partners have to agree on any changes, communication and compromise are the order of the day.

However, not every partnership can start out being 50/50. For whatever reasons, the seller does not want to give up control and practice income immediately, while the buyer wants to be assured that it will receive an increasing share of practice income over time, eventually becoming a full 50/50 partner. This approach can also work in reverse, reducing a 50/50 partner's ownership over time to full retirement. There are a variety of legal approaches used to achieve these results, with varying tax ramifications. This is the focus of this article: to compare the tax effects on buyer and seller of the different legal approaches available for building sweat equity ownership.

Tax Ramifications of Sweat Equity Transactions

The basic understanding professionals have of sweat equity is that the associate will earn a certain amount of credit as he works at the practice, and that credit will be converted into a growing partnership interest in the practice, and that the owner will continue to receive its full complement of cash flow from the practice. Unfortunately, what the associate and the owner fail to realize is that earning ownership through sweat equity is a taxable event that must be reported to the Internal Revenue Service ("IRS") and state tax authorities.

Associate Tax Ramifications of Sweat Equity

When the associate receives its partnership interest, the owner is required to report the fair market value of that interest as compensation to the associate via W-2 (employee) or 1099 (independent contractor). The value of the interest received by the associate is treated as compensation, and therefore is subject to income and payroll tax (employee), or income and self employment tax (independent contractor). That value is also added to the associate's "tax basis" in the partnership (the tax basis is the non-taxable amount the associate receives from a future sale of that partnership interest). If the value of the partnership interest earned did not have a specified value, a formal appraisal of the practice should be made at the time the associate receives its partnership interest to establish the fair market value on that interest.

Owner Tax Ramifications of Sweat Equity

The owner is required to report the fair market value of the partnership interest given to the associate as associate compensation via W-2 or 1099. The owner is allowed to take a tax deduction for the amount reported. If the associate is an employee, the owner pays its own half of the payroll taxes on that amount, and withholds the associate's half prior to disbursement. The owner owes short or long-term capital gains tax on the fair market value of the partnership interest received by the associate.

Non-Reporting of Sweat Equity Transaction

If the associate and the owner have not considered the associate's receipt of sweat equity as a taxable event, and their respective CPAs either don't know about the transaction or choose not to include it in appropriate tax returns, the

transaction has not been reported to the IRS. Interestingly, failing to report the transaction (to the IRS) places the associate at risk for its worst possible tax result, and in fact, gives the owner its worst tax result! It also provides the owner with substantial financial incentive to amend its tax return to properly report the transaction, or to have the transaction audited. (See *Summary of Tax Results* below for details.)

Alternative Approach: Associate Compensation Followed by Partnership Buy-In

There is a much better way to structure the sweat equity transaction: to have the associate (a) receive its sweat equity as compensation, (b) pay taxes on that compensation, (c) use the remaining funds to buy the sweat equity percentage of the partnership assets, and (d) contribute those assets to the partnership for an interest in the partnership. This step-by-step transaction turns the associate's sweat equity into a deductible purchase, while the owner reports a taxable sale. The same procedure is used with subsequent sweat equity transactions, including a final buy-out of the retiring partner.

The associate pays income tax and self employment tax on the buy-in amount, and the remainder is used for the buy-in. The associate immediately deducts the value of tangible assets and a small portion of goodwill, and deducts the remaining goodwill over the next fourteen years. This approach is far better for the associate, since the tax hit is now less than 50% of a straight sweat equity transaction. The owner, in turn, pays income tax on the sale of tangible assets and capital gains tax on the sale of goodwill; however, the owner avoids paying income and payroll taxes on the buy-in amount, since it is no longer treated as owner compensation.

Summary of Tax Results

Here are the final tax comparisons for the various approaches. We will assume a $500,000 total practice value and $50,000 of pre-tax sweat equity earned[1]. Amounts are rounded to the nearest $500:

1. **No IRS Reporting of Sweat Equity / No IRS Audit:** 10% of the practice is owned by the associate. Zero tax is paid, and a zero tax basis in the partnership is received, by the associate. $21,500 of tax is paid by the owner on its additional reported $50,000 gross compensation.

2. **No IRS Reporting of Sweat Equity / IRS Audit:** 10% of the partnership is owned by the associate.

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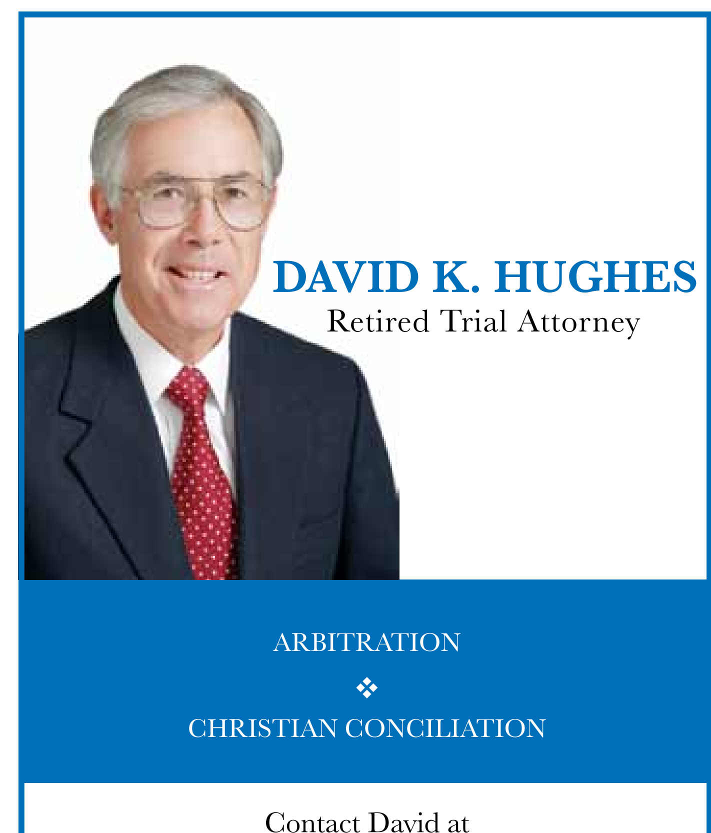

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$20,500 of tax plus interest is paid (includes 25% negligence penalty; fraud penalties are higher), and a zero tax basis in the partnership is received, by the associate. $12,500 of tax is paid by the owner (with an amended return) on its $50,000 gross sale proceeds.

3. **IRS Reporting, Sweat Equity:** 10% of the partnership is owned by the associate. $16,500 of tax and a $33,500 tax basis is attributed to the associate. $12,500 of tax is paid by the owner on its $50,000 gross sale proceeds.

4. **IRS Reporting, Buy-In:** 6.7% of the partnership is owned by the associate. $6,500 in tax is paid, and a $33,500 tax basis is received, by the associate. The associate also reduces its taxes by $700 per year for the next fourteen years. $9,900 in tax is paid by the owner on its $33,500 gross sales proceeds.

Owner Incentives in Tax Results

The best tax result for the owner is #4 (the Buy-In), followed by #3 (Reported Sweat Equity). The Buy-In gives the owner the greatest tax savings, gives the associate the smallest percentage of the partnership, and fully complies with IRS requirements. The Reported Sweat Equity has a similar tax result, but the associate gets a larger share of the practice.

Associate Incentives in Tax Results

For the associate, the situation is more muddled. The lowest current tax cost is #1 (Non-Reported Sweat Equity), but that is the worst tax result for the owner, and will result in significantly higher taxes to the associate when it sells its partnership interest (an additional $33,500 in basis is now subject to tax).

Many associates might want to play the "audit lottery" by asking for the Non-Reported Sweat Equity and betting against an audit – and associates and owners who don't want the hassle of proper reporting may also choose this route. A long-time CPA for professional practices tells me that he has never seen the IRS audit one of these transactions. However, the owner has a $9,000 tax incentive to report the transaction; if reported, it would guarantee an IRS audit of the associate's tax return. I would strongly advise associates against taking this route.

While staying in IRS requirements, the Buy-In is clearly the best tax result for the associate. The associate's tax is limited to $6,500 without risk from an IRS audit, taxes on a future sale are significantly lower since the tax basis is $33,500 higher, and the owner will like receiving its best tax result. Taxes are also fairly proportioned between the associate and the owner. The only drawback is that the associate has only received 2/3 of its value in the $50,000 buy-in. The Reported Sweat Equity doesn't work for the associate because the associate's taxes are prohibitively higher.

Buy-In Compromise for Mutual Benefit

I would suggest a wrinkle to the Buy-In scenario. Presumably, the associate has worked at the practice for a full year, and will have created some of its own goodwill in that time. Shouldn't that associate's goodwill be taken into account when the associate buys into the partnership? By granting a 10% interest in the partnership for the $33,500 purchase price (the "Buy-In Compromise"), the owner eliminates the associate's only drawback for the Buy-In. In fairness, the associate probably has contributed at least the minimal 3.3% ($16,500 worth) to the overall value of the practice over the year, so granting that additional small percentage is not unreasonable. The IRS also should not object to valuing a 10% interest in a $500,000 practice at only $33,500, because it is a minority interest and therefore not as valuable as a controlling interest. The parties would already expect that the 10% holdback in compensation would result in a 10% partnership interest, and any other treatment and explanation could easily be misunderstood in a way that would interfere with the partners' relationship. Finally, if the owner grants, without debate, the full 10% partnership interest the associate was expecting, the owner doesn't prompt the associate to argue for more than the additional 3.3% interest for its own efforts over the past year! To summarize the tax results:

5. **IRS Reporting, Buy-In Compromise:** 10% (rather than 6.7%) of the partnership is owned by the associate. $6,500 in tax is paid, and a $33,500 tax basis is received, by the associate. The associate also reduces its taxes by $700 per year for the next fourteen years. $9,900 in tax is paid by the owner on its $33,500 gross sales proceeds.

Conclusion

The Buy-In Compromise gives the parties (a) the lowest total tax burden, (b) the fairly apportioned allocation of that tax burden, (c) the fair recognition of the associate's contributions to the practice, and (d) a meeting of the parties' ordinary

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On January 14, 2012, **John J. Thyne III** (president of **Santa Barbara County Bar Foundation**) will marry his long time love **Olesya Dracheva** in a church ceremony at Our Lady of Sorrows Catholic Church followed by a reception at the Montecito Country Club. Congratulations, John and Olesya!

On January 17, 2012 at 6PM at Harry's Plaza Café 3313 State Street, the **Santa Barbara Paralegal Association** will hold its annual dinner meeting with the installation of its 2012 board of directors and officers. Santa Barbara **District Attorney Joyce Dudley** will officiate and also give a presentation titled, "**There's a New D.A. in Town: Changes, Practices and Procedures for the Santa Barbara County District Attorney's Office**." The SBPA is especially excited as this will be the first MCLE program offered to the attorneys, paralegals and legal professionals in our region that will be directly accredited by the California State Bar Association. The SBPA is currently pursuing a "multiple [MCLE] program" provider status with the California State Bar Association, and is expected to be granted this status in the first quarter of 2012. The event will be worth 1 Hour of MCLE general credit, and will cost $25 for SBPA Members/$35 for Non-Members. Please RSVP to CourtConnectioninfo@sbcourtconnection.com by Friday, January 13, 2011 and mail checks to Court Connection, LLC, 315 Meigs Road, A130, Santa Barbara, CA 93109.

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Brownstein Hyatt Farber Schreck is pleased to announce that **Dylan K. Johnson** has joined the Santa Barbara office as an associate in the firm's natural resources group. His practice focuses on land use and public law. Prior to joining Brownstein, Mr. Johnson was an extern for the U.S. Environmental Protection Agency (EPA), ORC, Region 5 in Chicago. His work for the EPA included writing memoranda for the federal and state implementation of National Pollutant Discharge Elimination System permits, drafting final determination letters for violations of environmental statutes, and preparing reports regarding penalty variances in EPA administrative law courts. Mr. Johnson is conversational in Mandarin Chinese and used his language skills to teach middle school and professional students in Taizhou and Shanghai, China. Mr. Johnson received his law degree from the Notre Dame Law School and his bachelor's degree from Indiana University.

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expectations for the transaction. The Buy-In Compromise is a fair, winning result for everyone involved. ■

© 2010-2011 by Robert W. Olson, Jr. Mr. Olson is an attorney focusing on business organizations since 1986 and professional practice transitions since 1992.

ENDNOTES

[1] Tax assumptions are for combined federal and state rates, as follows: a marginal 30% income tax rate for the associate (who is paid as an independent contractor), a 40% marginal income tax rate for the owner, both associate and owner paying the additional 2.9% Medicare tax on income, and a 25% capital gains rate for the owner. We also assume that the associate moves up to a 40% marginal income tax rate once he becomes a partner. The tax allocation on the Buy-In is assumed to be 25% to tangible assets and 75% to goodwill.

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