

# Succession Planning for Dental and Dental Specialty Practices

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## William P. Prescott and Mark P. Altieri

**OF THE** approximately 27,000,000 privately owned businesses in the United States, only 6,000,000 have employees.<sup>1</sup> An interesting segment of those businesses are certain professional practices with value that can be sold and transferred. Dental and dental specialty practices continue to maintain the highest values, well ahead of veterinary, optometry, and many medical practices. As such, this article discusses the exit choices for dental and dental specialty practices in light of determining their value.

**EXIT CHOICES** • If a dentist (including dental specialists) has sufficient savings, knows how he or she will spend time after retirement and wants to retire, there are six ways to do it. They are a complete sale, hiring an associate with a later sale, co-ownership, a solo group arrangement, merger, and walk away.

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<sup>1</sup> *Succession Planning for Closely Held Businesses and Professional Practices – II / Planning for the Successive Transition of a Family Business to the Next Generation*, Morton A. Harris, Hatcher, Stubbs, Land, Hollis & Rothschild, September 19, 2014.

## Complete Sale

A complete sale is relatively simple as compared to other exit choices, with the exception of closing the doors. Unlike 20-plus years ago, the dentist should be fully paid in cash at closing. For large practices, there may be a component of seller financing of up to 20% of the selling price.

Depending upon the size of the practice, the continued employment of the seller by the purchaser may be necessary to transfer the seller's goodwill, finish cases and provide treatment as requested by the purchaser for an agreed time period, typically six months to one year and by mutual agreement thereafter. The dentist should be paid the greater of a daily rate or half-day rate or an agreed percentage of production or collections, often 35% for a general dentist and higher for specialists. The daily rate accounts for greeting and administrative time and assures that if the selling dentist works, he or she will be paid irrespective of the treatment schedule. While laboratory costs should be paid by the purchaser's practice, the selling dentist's direct business expenses, insurances, and benefits not paid by the purchaser's practice would be reduced and offset from the selling dentist's compensation calculation. While the seller and purchaser would like the seller to be classified as an independent contractor for expense deduction purposes, the retired dentist who continues to work is probably an employee.<sup>2</sup>

In the past three or four years, corporate practices have become prevalent purchasers, despite many state laws prohibiting non-dentist ownership. They are providing selling dentists with an additional choice as buyers. If the dentist sells to a corporate buyer, the dentist should be fully paid at closing, without any hold back for one or two

years based upon practice performance. The dentist should not accept stock in lieu of any portion of the purchase price as there is a very limited market to later sell it. While easier said than done, always attempt to ensure that the selling dentist is not required to continue to work for the corporate practice post-closing should he or she not desire to do so.

## Hiring an Associate With a Later Sale

To the extent that the practice owner has a practice that requires strong mentorship due to high-level or "unique" services or the practice owner believes that he or she has located the right successor and the practice has sufficient production, but the owner is not ready to retire, this exit strategy has merit. Here, the practice owner and the associate sign the associate employment agreement, the purchase and sale agreements and the practice owner's post-closing employment agreement. The signed purchase and sale agreements close one to three years from the date of the associate's employment or the earlier of the practice owner's death, disability or election to retire. Because this exit strategy often involves a large practice that can support an associate, it is more likely here, than with a complete sale, that the former owner will continue to work post-closing.

This exit choice is a very desirable alternative to co-ownership if the practice owner plans to work less than six years, as it usually takes seven years to pay for the first half of the practice in co-ownership. As an example, the associate works for the practice for three years, then the former owner works for the associate for three years and by mutual agreement thereafter. If the new owner fires the former owner without cause, the former owner's restrictive covenant could become null and void. Similarly, if the practice owner does not sell the practice under the terms of the agreement, the associate's restrictive covenant may become null and void.

<sup>2</sup> *Legislation Affecting Your Practice*, Dental Economics, William P. Prescott, E.M.B.A., J.D., September 2011; *Worker Classification Issues in Professional Practices*, The Practical Tax Lawyer, William P. Prescott, E.M.B.A., J.D., Mark P. Altieri, J.D., LL.M., CPA, PFS and Kelly A. Means, J.D., Summer 2010.

To justify that the practice owner is taking the practice off the market by this arrangement, we suggest an earnest money deposit in the form of a promissory note in an agreed upon sum. If the associate does not purchase the practice, except for specified reasons, the promissory note becomes immediately due and payable. The practice owner may also be subject to a comparable promissory note that would become immediately due and payable should the practice owner decide not to sell the practice. This form of earnest money deposit is favorable to an associate because it does not require an up-front deposit. Depending upon the state, the court may limit damages for breach of contract to the sum of the earnest money deposit. Because of this concern, the sum of the promissory note(s) should be carefully considered.

As a fail-safe, if 100% financing is not available in the future, despite the purchaser's best efforts, either the obligation to purchase the practice becomes null and void or the terms of any owner financing, to the extent that the practice owner is willing to provide it, are delineated in the agreements.

As to the determination of the purchase price, the practice is valued as of a date before the associate's employment begins. The practice is again valued in one year after the associate period. The rationale is that in one year, the associate's production is attributable to the pent-up demand of the practice. Often, the associate is from the community where the practice is located. While those patients directly attributable to the associate can be excluded from the goodwill calculation, the reality is that the patients directly referred to the practice will be *de minimis*. New equipment and technology purchased during the associate period should be as mutually agreed over a threshold dollar amount, except for emergency purchases, and depreciated over a 10-year straight-line method. For example, if the practice owner and the associate agree to purchase technology which costs \$40,000 at the

end of year one of the associate period that will last three years, the purchase price for the technology will be reduced by \$4,000 in year two and \$4,000 in year three, and the fair market value is \$32,000.

What's beneficial about hiring the associate with a later complete sale is that there is one owner and an asset sale that is mostly capital gains to the practice owner with the assets being deductible by the purchaser. An exception is for a son or daughter purchasing a parent's practice which was formed prior to August 10, 1993 due to the harsh anti-churning rules under the tax code.

### **Co-Ownership**

Co-Ownership is the most complex form of practice ownership because the parties need to deal with the buy-in, operations (consisting of compensation allocations, decision-making, control and employment of family members as dentists/specialists and/or non-doctor staff), and, most overlooked, an owner's buy-out for any reason. Added to this complexity, there are three business and tax structures for co-ownership, two of which do not work very well if the tax rules are followed. Those business and tax structures are as follows: (1) the purchase and sale of stock in a corporation or a membership interest in a limited liability company, excluding goodwill and a compensation shift for the buy-in and deferred compensation for an owner's buy-out, adjusted upward to reflect the differential of Dr. Senior receiving ordinary income and again for an interest component; (2) the three-entity method, consisting of a limited liability company or partnership of corporations to achieve favorable asset treatment for those practices formed after August 10, 1993 due to the anti-churning rules; or (3) purchase and sale of stock in after-tax dollars and adjust downward to reflect that the purchaser is purchasing stock in after-tax dollars while Dr. Senior receives all capital gains, which is the only business and tax structure always without tax

risks.<sup>3,4</sup> Notwithstanding IRS scrutiny in these complex transactions, co-ownership is becoming more and more common due to large general and specialty practices that cannot be sold in a complete sale due to size.

The buy-in will be internally financed unless Dr. Senior is willing to provide the lender with a guaranty through the practice entity and/or Dr. Senior personally. If the new owner leaves, Dr. Senior is required to repay the loan. As such, the buy-in should be internally financed. As to the buy-out in a two-owner practice (by far the most common), Dr. Senior should be paid in cash and Dr. Senior's buy-out should be mandatory by the associate. Unfortunately, the associate may not desire to buy the second half of Dr. Senior's practice and complete the buy-out unless it is mandatory. This is a big problem in co-ownership, second only to production disparity due to insufficient patient demand.

While an associate buy-in has traditionally been on a pro-rata basis, e.g., 50% / 50% in a two-owner practice, to the extent that the CPA for the practice utilizes distributions if the practice entity is organized as a S-corporation, the buy-in will be structured in a manner for the stock to be paid on the yearly basis as S-corporation distributions are made on the basis of ownership.<sup>5</sup> For example, if the buy-in takes place over five years, Dr. Junior purchases 10% of the stock per year; if over seven years, Dr. Junior purchases 14.28% of the stock per

year. If Dr. Junior would purchase 50% of the stock immediately under a promissory note and pledge and security agreement, then Dr. Junior would receive 50% of the S-corporation distributions without having paid for 50% of the stock.

In a more than two-owner practice, the second owner admitted does not want to be affected by Dr. Senior's departure. Because Dr. Two does not want to be affected by Dr. Senior's departure, the buy-out in a more than two-owner practice is paid over time by Dr. Three and any other remaining owners.

In co-ownership, it is essential to have the buy-sell agreements in place. Depending upon the business and tax structure, there may be more than one. Owner buy-outs can be mandatory or optional. Mandatory is highly recommended, although an exception is two or more owners approximately the same age. The buy-sell agreements should track the selected business and tax structure and consider the triggering events of death, disability, or retirement as a defined term, termination of employment for any reason or election by an owner to leave. If a new owner leaves the practice, the buyout formula is reduced if Dr. Junior has not lived up to the obligations to buy out Dr. Senior and further reduced by any unpaid amount owed by Dr. Junior. There is no windfall to Dr. Junior to leave. Similarly, if Dr. Senior retains the ability to, and in fact does terminate Dr. Junior's employment without "cause," Dr. Junior's buy-out is increased under the buy-sell agreement formula. The reduction to Dr. Junior or increase to Dr. Senior is often 50% of the buy-out formula.

Buy-sell agreements should always contain restrictive covenant provisions in accordance with state law. We do, however, make certain exceptions to the restrictive covenant. As an example, an unrelated third-party dentist joined husband and wife owners as a shareholder. Provided that the third owner paid for his pro rata interest in the practice, the third owner could leave and elect to practice

<sup>3</sup> *Co-ownership In Dental Practices: It's Taxing*, The Practical Tax Lawyer, William P. Prescott, E.M.B.A., J.D., Summer 2012; *Co-ownership — a taxing relationship*, Dental Economics, William P. Prescott, E.M.B.A., J.D., September 2010.

<sup>4</sup> *Professional Practice Transitions, Section 197, and The Anti-Churning Rules*, The Practical Tax Lawyer, Mark P. Altieri, J.D., LL.M., CPA, PFS, William P. Prescott, E.M.B.A., J.D. and Phillip Thornton, Ph.D., Winter 2011.

<sup>5</sup> *Payroll Taxable Wages Of An Owner And Employee Of An S Corporation*, The Practical Tax Lawyer, Mark P. Altieri, J.D., LL.M., CPA, PFS, William P. Prescott, E.M.B.A., J.D. and Kelly A. VanDenHaute, J.D., Winter 2012.

within the restricted area. In that case, the third owner would only have received a pro rate value of the tangible assets at the time of departure. Fortunately, he is still there.

As an interesting observation where we have handled owner disputes, there are usually outdated buy-sell agreements, or, more often, no signed buy-sell agreements at all.

### **Solo Group Arrangements**

Solo group arrangements are a good alternative to co-ownership because the associate who purchases the first half of the practice is not obligated to purchase the second half. Because the practice owner and the associate, now an owner, have separate practices, the existing owner sells his or her practice at retirement to a third dentist. This works well because the third dentist is not a co-owner with the other solo group member. In a solo group arrangement, the existing owner sells one-half or an undivided interest in the equipment, technology, and goodwill. Thereafter, the existing and new owner, the former associate, operate their now separate practices under an office sharing agreement. Common expenses to both practices are either equally allocated or allocated on the basis of respective productivity. This exit choice resolves the anti-churning rule problem, in contrast to the three entity method, to achieve favorable asset treatment for the seller and purchaser because they are unrelated for practices formed prior to August 10, 1993. An exception is for family members.

### **Merger**

For those practices that are relatively small or unsalable for any reason, they can be merged into a larger practice with adequate space. The practice owner continues to work and when ready to retire, the purchaser's practice purchases the practice owner's patients under an agreement over 12 months. The selling price is often 35% of the purchasing practice's collections attributable to his or

her goodwill or revenue generated from former patients. The purchasing practice pays only for the goodwill actually transferred. There may be an initial payment upon the practice owner's retirement, often half of the anticipated or calculated goodwill value, with the second half "trued-up" after 12 months from the sale. Usually the purchasing owner does not need the practice owner's equipment, except for specified items. One reason that merger is becoming more common is that new dentists and specialists cannot earn a reasonable living, cover their living expenses and service school debt by purchasing a small practice. As a result, these dentists, and now specialists, are joining corporate practices rather than buying a smaller practice and then developing it.

### **Walk Away**

Assuming that the dentist can afford to retire, the practice owner can elect to work one or two years longer than anticipated and then close the doors. As an example, the practice collects \$800,000 in a year. Yearly earnings are \$320,000 or 40% of collections. By working two more years, the practice owner earns \$640,000, maybe \$500,000 if more time is taken off. If the practice sells for 65% of one year's collections or \$520,000, the practice owner hasn't lost anything. If a successor is available when the practice owner is ready to leave, the practice owner sells. If not, the practice owner walks away.

Some specialists and general dentists in certain geographical areas have no choice other than to close the doors should a successor not be available. While the practice owner is not paid for the practice, the practice owner is not faced with the complexity of selling it.

### **Summary**

A complete purchase and sale is the least complex. The seller gets fair market value for the practice and goodwill is paid in cash with maybe a small

percentage of seller financing. If the practice owner has identified his or her successor and is sufficiently busy, admitting an associate with a complete sale in one to three years is workable, although more complex than a complete purchase and sale. If the practice owner plans to practice full time for seven-plus years, co-ownership can work so long as Dr. Junior is willing to purchase the second half of Dr. Senior's practice. A solo group arrangement often works better than co-ownership because Dr. Junior probably does not want the obligation to purchase the second half of the practice. A merger can work well for an otherwise unsalable practice. Finally, the practice owner can work an additional one or two more years and walk away.

**DENTAL PRACTICE VALUES** • While lawyers are not usually involved in the valuation of the professional practice involving a complete or fractional sale and purchase, it is important to understand the process to ensure that the economic terms are fair to all concerned.

### Valuation Methods

Three common methods of valuing professional practices are summation of assets, capitalization of earnings, and similar practices. The methodology is the same for a complete or fractional sale and purchase. Accounts receivable are excluded from the valuation and may be included or excluded from the transaction.

### Asset Summation

The asset summation method calculates fair market value of: (a) tangible assets consisting of professional equipment, office equipment, furniture and technology (the "Tangible Assets"); (b) supplies; (c) medical or dental instruments; and (d) goodwill, be it personal to the practice owner or the practice entity.

### Tangible Assets

The fair market value of Tangible Assets can be calculated by the equipment company that sold and services the equipment. Another method is the book value, plus add one-third of the depreciation previously taken without regard to accumulated depreciation. Finally, a 10-year straight-line depreciation can be used with a 20% salvage value.

### Supplies

Determine the supply level normally on hand, then determine the cost of supplies for the last calendar or fiscal year, divide by 12, and multiply by the number of months of supplies on hand. This would be three to four months in a dental or dental specialty practice.

### Instruments

Instruments are typically a small percentage of one year's collections. In dental or dental specialty practices, it is usually .5% of one year's collections.

### Goodwill

The Goodwill Registry<sup>6</sup>, compiled yearly by The Health Care Group, Inc., provides a 10-year running average for almost all professional practices. Medical practices are on the low side with goodwill calculated at roughly 20% of one year's collections. Dental and dental specialty practices are the highest with goodwill of 46.85% as the statistical mean in a general dental practice. The Goodwill Registry lists the number of practices reviewed and provides categories of no goodwill, statistical mean, statistical median, high and low. In addition, some medical professions have publications on goodwill and practice values. For example, the most recent version of the American Dental Association's publication<sup>7</sup> states that goodwill based on annual col-

<sup>6</sup> *The 2013 Goodwill Registry*, The Health Care Group, Inc., Plymouth Meeting, PA.

<sup>7</sup> *Valuing a Practice, A Guide for Dentists*, Practice Management

lections should range between .2 and .5. Where goodwill is based upon annual owner/doctor compensation in all forms, the multiple ranges between 1.0 and 1.5.

### Capitalization of Earnings

The term “capitalization rate” can be thought of as the percentage by which a constant income stream is divided in order to obtain the value of a business on the basis of an assumed rate of return.<sup>8</sup> In other words, the income stream is the yearly cash flow available to pay the purchase price. Assuming that this sum is an even amount each year, the reciprocal of the payback period could be regarded as the capitalization rate.<sup>9</sup> A 20% capitalization rate equates to a five year repayment period and a 14.28% rate equates to a seven year repayment period. The lower the capitalization rate, the longer the repayment period. A 20% capitalization rate is often used in the valuation of professional practices, particularly for dental and dental specialty practices. Capitalization rates are based upon the nature of the business, the risk involved and the stability or regularity of earnings.<sup>10</sup>

### Similar Practices

This overused valuation method is a generalization as few practices in the same profession have identical values, even with similar levels of annual collections. One professional practice may have greater or lower profitability than another, as well as other factors which make one practice distinct from another, such as location, square footage, or method of patient payment, e.g., fee for service or reduced fees. Similar practice values are often used

in destination locations where there is usually high demand by candidates who are looking for practice opportunities, where few exist.

### Verification Analysis

The seller or practice owner almost always engages an appraiser to prepare the valuation report. If representing the purchaser or the incoming owner, how do you know if the valuation is fair?

Rather than engaging an appraiser to prepare a second valuation report, consider having the CPA for the purchaser complete a verification analysis to determine if the proposed selling and purchase price makes sense:

- First, the purchaser or incoming owner must earn a “reasonable” rate of compensation while paying for the practice or fractional interest purchased. The new owner should generally not agree to a pay reduction or be paid less than a non-owner to purchase a practice or fractional interest;
- Second, the purchaser or incoming owner must pay his or her operating expenses in the practice. If additional capital expenditures are necessary, this will reduce the yearly available cash flow to pay compensation to the new owner and the purchase price;
- Third, the purchaser or new owner must pay the lender(s);
- Finally, the purchase price must be repaid within a measured period of time. Assuming that the sum of the purchase price paid each year is the same, a 10-year repayment period costs more than a five or seven year repayment period.

If the selling and purchase price is acceptable, proceed with the transaction. If not, negotiate the selling and purchase price which may, at this point, necessitate a second appraisal. Averaging the appraisals does not work because the above four crite-

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Series, American Dental Association, 2006, p. 47.

<sup>8</sup> *Valuing Small Businesses and Professional Practices*, Shannon Pratt, Dow Jones-Irwin, 1986, p. 122, 123.

<sup>9</sup> *Valuing Small Businesses and Professional Practices*, Third Ed., Shannon P. Pratt, Robert F. Reilly, Robert P. Schweiths, McGraw-Hill, 1998; p. 229.

<sup>10</sup> Revenue Ruling 59-60, Section 6.

ria must be met or the transaction will not be successful.

### **Balancing the Tax Effects**

Valuations of professional practices are calculated on a tax-neutral basis that is without regard to whether the seller or purchaser receives favorable tax treatment, especially in the sale and purchase of a fractional interest. Where one party receives favorable tax treatment and the other does not, the selling and purchase price should be adjusted to make the transaction tax neutral. For example, for the purchase and sale of stock in after-tax dollars, the value is reduced because the incoming owner cannot amortize the purchase price. Where the stock excludes goodwill and a compensation shift is used for the buy-in and deferred compensation for the buy-out, that portion of the purchase price is increased by some percentage of the difference between capital gains and ordinary income to the existing owner and again for an interest component.

### **Observation**

Interestingly, professional practice valuations do not consider whether goodwill is personal versus enterprise or corporate. This analysis requires a separate appraisal and appraisers who will value the nature of the goodwill are difficult to locate, probably due to potential audit concerns. In reality, the CPAs generally determine to what extent any goodwill is personal versus enterprise or corporate where the professional practice is organized as a C-corporation. Most professional practice appraisers do value each category of assets and will place a value on goodwill, but will not distinguish its character.

**CONCLUSION** • It is not enough only to assist our clients in determining the best exist choice for them, it is also important to ensure that the value of the practice is properly determined for a successful change of ownership.

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