

Chapter 2

ASSESSING SUCCESSION OPTIONS

Let's assume that Dr. Smith is considering retirement at some point and can answer two questions. Can I afford to retire given anticipated life expectancies? What will I do with my time? If the answers are affirmative, what are Dr. Smith's options? They may be to: (i) completely sell the practice and retire; (ii) hire an associate and later retire; (iii) hire an associate and sell a portion of the practice in a solo group arrangement, whereby the practices remain separate; or (iv) hire an associate who will become a "partner" after a successful trial period. If Dr. Smith cannot find a suitable candidate, a fifth option may be to work for a year or two, then close the practice. Let's say that Dr. Smith is not sure whether to completely retire or work on a limited basis for an indefinite period of time. Both the solo group and partner models provide for Dr. Smith to remain in practice.

In reviewing the succession options with Dr. Smith, a key factor will be time. The more time Dr. Smith has prior to retirement, the more options Dr. Smith has. This assumes that Dr. Smith has enough money in his retirement plan and other assets to the practice by choice. A harsh reality is that many doctors continue to work not because they necessarily want to, but because they have to.

Irrespective of the succession option, the purchase price, terms and structure of the sale and acquisition must be agreed upon. Practices used to sell for approximately 65% of one year's gross collections.¹ In May, 1999, values were dropping to approximately 55% after negotiations² and still continue to do so. The decline in values is due in large part to supply and demand of new doctors. Practices with healthy profitability, however, sell for higher value than those without effective management systems which create healthy profits.

Complete Sale

The complete sale is the simplest form of practice succession. You locate a purchaser, sell the practice, hopefully for cash, and retire.

Structuring the Sale

Dental practices are generally sold through either an asset or stock sale. Under either method, the seller attempts to come out with as much cash as possible at low capital gains rates. The purchasing doctor wants tax deductibility and shorter versus longer write-off periods for the practice acquired.

¹ Shannon Pratt, *Valuing Small Businesses and Professional Practices*, Dow Jones-Irwin Homewood, Illinois, 1986, page 361.

² Dr. James R. Pride, Brian C. Hufford, CPA, CFP, William P. Prescott, MBA, JD, *Dental Business Monthly*, Pride, Hufford & Prescott, LLC, May, 1999, page 1.

Asset Sale

In an asset sale, the purchaser acquires all or part of the seller's assets and probably would not want to assume any of the seller's liabilities, e.g., amounts owed on dental equipment or expansion loans. Purchasing doctors like asset transactions because they are not acquiring liabilities and can write-off the acquired assets in accordance with the tax code. For example, dental equipment is depreciated over 7 years and goodwill over 15 years. Selling doctors receive capital gains on goodwill which typically comprises the biggest part of the sale. However, where a practice operates as a C corporation, the sale of assets results in a double tax; a 35% tax at the corporate level and capital gains rates at the shareholder level when assets are distributed. This is a significant problem for the selling doctor.

Because of the outcome of two tax cases in 1998,^{3, 4} goodwill can be "personal" to the shareholder/doctor. Although still an open question for tax purposes, if the goodwill is a personal and not a corporate asset, then the double tax on the sale of a C corporation's assets can arguably be avoided.

The double tax problem for the seller is avoided through the sale of stock, although the purchaser cannot write-off the purchase price and typically does not want to acquire the liabilities associated with the purchase of stock.

Stock Sale

If the practice is organized as an S or C corporation, the selling doctor can sell either the assets or the stock of the professional corporation. However, in a complete sale, stock is not usually sold because the purchaser wants to write-off the purchase price. In a stock sale, the purchaser cannot write-off the stock and, therefore, acquires the stock in after-tax dollars. In the sale of stock, the selling doctor receives favorable capital gains rates. In the sale of stock, the purchaser also acquires the unknown or "contingent" liabilities of the practice. However, this problem can be minimized by the seller agreeing to "hold harmless" or "indemnify" the purchaser from any liability which accrued prior to the date of sale. Where stock is sold, the selling price may be adjusted downward to reflect the tax detriment to the purchasing doctor acquiring stock in after-tax dollars and the tax benefit to the seller who receives capital gains on the sale of stock. In the purchase of stock, the purchaser receives a "basis" equal to the purchase price. When the purchaser later sells his or her stock, the purchaser pays capital gains only on the portion of the selling price above the basis in the stock. When the purchaser later sells his or her stock, this becomes an advantage.

Letter of Intent

A letter of intent precedes the sale and acquisition documents. The provisions in the letter of intent provide a written request by the seller or purchaser of the price, terms and conditions of the sale and acquisition. Once the letter of intent is agreed upon by the parties, then the

³ Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1989).

⁴ Norwalk v. Commissioner, 76 T.C.M. 208 (1998).

documents for the transaction can be drafted. The letter of intent may also include an earnest money deposit, which would be forfeited if the purchaser backs out for specified reasons.

Financing the Purchase Price

If you are completely leaving practice, request the purchase price in cash. While it is beneficial to receive the interest on the sale and pay taxes you receive the proceeds over time, there is always the risk of default. A prediction is that cash sales may be uncommon in the future.

Your Continued Employment

You may work with a purchasing doctor for some period of time to transfer patients and/or referral sources. During this transition period, you render professional services, perhaps finish up cases, and introduce the purchaser to patients and/or referrals sources. In a specialty practice, you may be paid a daily or a half day rate for the services you provide. Your compensation may also differentiate between rendering professional services and introductions. Your work schedule should be defined in advance and may not exceed a specified number of days or hours per week. You would work under to an employment agreement with the purchaser which agreement would provide for who pays the cost of malpractice insurance premiums, continuing education costs, professional dues, health insurance premiums, fringe benefits, other business expenses and any continuation of retirement plan and benefits. The agreement would also define your work schedule, provide for any time-off and termination of employment provisions. Restrictive covenant provisions, however, would be contained in the sale and acquisition documents and your continued employment with the purchaser would be an exception those restrictions. The more "unique" your practice, the longer period of time it will take to successfully transfer patients and/or referral sources to a purchasing doctor(s).

Sale and Acquisition Documents

An asset sale is made in accordance with the terms and conditions of an asset purchase agreement, while the sale of stock is made in accordance with the terms and conditions of a stock purchase agreement. Both documents contain similar provisions dealing with the date of sale and purchase, determination of purchase price, payment of the purchase price, indemnification/hold harmless provisions, representations and warranties, rework and non-competition provisions.

Usually, the sale and purchase of a dental or dental specialty practice works very well for all parties, provided that the purchase price is "fair". Let's say that Dr. Smith, the retiring doctor, had his practice "fairly" appraised and that the respective advisors for both Dr. Smith and the purchaser, Dr. Jones, agreed with the appraisal, price and structure of the proposed transaction. Dr. Smith sold the tangible assets of his professional C corporation for their appraised fair market value, which resulted in a seven year write-off for Dr. Jones. Dr. Smith also agreed to sell his personal goodwill and agreed not to compete with Dr. Jones. This resulted in capital gains to Dr. Smith at one tax level outside of the professional C corporation, which means Dr. Smith avoided double taxation. Dr. Jones' practice wrote-off the personal goodwill over 15 years. Dr. Smith remained employed with Dr. Jones' practice for one year after the closing. After Dr. Smith left the practice, Dr. Jones later hired an associate so that revenues continued to grow.

Why did this succession plan work so well? The practice price, terms and structure of the transaction was fair to all parties.

Hire Associate With Later Sale

This method of succession is similar to a complete sale. The difference is that an associate is hired by the practice, usually one to five years prior to the practice owner's retirement. The reasons that the associate is hired is that the practice is growing, the seller wants to work less and the practice provides a high level of professional services which require sufficient time for mentoring and training of the incoming doctor. The associate works under the terms and conditions of an employment agreement, which provides for the associate's schedule, compensation and bonuses, fringe and other benefits, payment of expenses, non-disclosure/non-competition promises, time-off and termination of employment.

At the time the associate signs the employment agreement with the practice, the associate also signs an asset purchase agreement and related documents for the sale and purchase of the practice assets and possibly the personal goodwill of the departing owner. The closing date for the sale and purchase of the practice will be the earlier of a specified retirement date, the death or permanent disability of the practice owner.

The purchase price may be definite or determined by a formula which may increase, or decrease, based upon changes in annual practice revenues and profits.

While these arrangements usually work well, the longer out the purchase date, the more significant the risk for the selling practice owner. Let's take the example of the associate doctor who agreed to buy out the practice owner and who later decided to enter into a specialty program or the doctor who decided that she no longer desired to practice on a full-time basis and chose to have a family. The further out the target date of closing, the more contingencies life presents. This impact may be minimized by requiring an earnest money deposit which would be forfeited in the event that the practice was not later purchased by the associate doctor. Hopefully though, you will be working with someone who will live up to their commitments.

Solo Group Arrangements

In a solo group, each doctor operates their respective practice as a separate entity under the terms of an office sharing agreement. The solo group model has the effect of expense sharing, but not the burdensome complexities of co-ownership. Here, the practice owner is not yet ready to retire, but is sufficiently busy to hire an associate and consistently keep that associate productive. The associate/candidate is located and hired under the terms and conditions of an associate employment agreement. Assuming that the practice owner and associate desire to work together over the long term and assuming that the associate attains certain predetermined productivity goals over a measured period of time, e.g., 2-3 years, the associate acquires the goodwill of the associate's "developing patient base"; those patients typically treated or the revenues generated by the associate. The associate also acquires an undivided interest in the tangible assets of the practice.

In the event of the death or permanent disability of an owner, the surviving remaining owner is usually required to buy the practice of the deceased or disabled doctor. Often, these involuntary events can be funded through insurance.

In the event of retirement of one owner, the remaining owner(s) is usually not obligated, but has the option, to acquire the practice of the retiring doctor. The reason for this is because the non-retiring owner does not usually have a need to acquire the second practice after building his or her own practice. In other words, the doctor who was your associate five or ten years earlier and who develops his or her own practice is not the person who will desire to buy you out upon retirement. This is one reason why co-ownership/groups fail.

The method of paying common employees in a solo group will definitely impact the retirement funding for each practice. Therefore, the payment of common employees should be carefully considered prior to the formation of the solo group. In short, if one practice pays retirement plan contributions or health insurance premiums on behalf of employees common to both practices, the practice which did not pay the retirement plan contribution or health insurance premium can be allocated its share of the costs under the office sharing agreement.

Co-Ownership

In co-ownership, you admit another doctor(s) to your practice as an owner prior to your retirement. Co-ownership is the most complex form of succession due to the difficulty in getting all owners to agree on crucial matters. This is one reason why co-ownership/groups fail. The five areas which owners must agree upon are: (i) allocation of compensation, bonuses, fringe benefits and retirement plan contributions; (ii) decision making and voting control; (iii) dispute resolution; (iv) admitting new owner(s); and (v) the buy-out of a departing owner. Because of these complexities, it is difficult to keep groups together. Where groups do stay together, the owners hold regularly scheduled meetings to discuss practice business. Communication is the key factor in keeping groups intact for long periods of time.

Allocation of Compensation

Compensation, bonuses, fringe benefits and retirement plan contributions are often allocated in one of five ways or through a combination as follows: (i) by respective productivity of one owner as a percentage of the productivity of all owners; (ii) by ownership percentage; (iii) equally; (iv) by management and administrative responsibilities; and/or (v) by the number of days, half-days or time spent working in the practice. Remember that retirement plan contributions are based on total compensation by law and it is difficult for multiple owners to agree on the same plan design and funding level.

The employment agreements for owners allocate compensation in all forms and contain the typical provisions contained in an associate employment with the following exceptions: (i) the compensation and bonuses are more generous for owners than associates; (ii) the restrictive covenants are generally for a longer period of time for owners than for associates; (iii) fringe benefit, expense and time-off policies are generally more liberal for owners than associates; and (iv) it is usually more difficult to terminate the employment of an owner versus an associate.

Decision Making and Voting Control

Decision making and voting control over the practice is an important decision. It can be equally allocated among the owners or vested in one or a group of owner(s) as "founder's rights". While the senior doctor likes to retain decision making control, new doctor(s) would propose that their buy-in price should be reduced to reflect a "lack of control" discount.

Dispute Resolution

Dispute resolution devices play an important role in co-ownership arrangements to resolve problems without use of the court system. Dispute resolution devices consider the issue of voting or decision making deadlock. Deadlock can usually be defined as any disagreement among any owner regarding the management or operational affairs of practice. An alternative to defining deadlock is to grant each owner the right to dissolve the practice at any time unless a predetermined deadlock remedy is undertaken. A buy-sell agreement may also serve as a deadlock remedy. In other words, deadlock would serve as a triggering event under a buy-sell agreement.

Associate Buy-In

The valuation of the practice in co-ownership is identical to the valuation in its complete sale, except that the incoming doctor acquires a proportionate interest in the practice. For example, if the incoming doctor produces 50% of the doctor revenues, the incoming doctor would acquire a 50% interest in the practice. If the incoming doctor produces 25% or 33-1/3% of the practice revenues, the incoming owner would acquire a 25% or 33-1/3% interest in the practice. The interest acquired by the incoming doctor should match his or her percentage of practice productivity. This allows the new doctor to both pay the practice interest and not reduce compensation below the associate level.

As part of the admission process, the new doctor would become a party to the practice agreements which provide for operation of the practice and the buy-out of departing owner(s).

Buy-Out of Departing Owner(s)

The buy-out of a departing owner(s) probably presents the single biggest challenge in co-ownership for continuance of future operations. A buy-sell agreement may provide for the mandatory or optional purchase of an owner's interest in the practice entity if a specified triggering event occurs. The decision between a mandatory or optional purchase and sale is often decided by the type of triggering event. An involuntary triggering event such as death or permanent disability or attaining a predetermined retirement age when the owner elects to retire, normally would require a mandatory buy-out. Any other termination of employment, voting deadlock or dispute may provide for a buy-out at the option of the non-departing practice owner(s).

The method of determining the price of a departing owner's interest may be difficult for the owners to agree upon, particularly where the shortage of doctors is reducing practice values. The buy-sell agreement price will either be based upon a formula which will reflect future growth

or provide for a specified purchase price. Both fixed values and formulas should be reviewed and discussed by the owners at an annual meeting with advisors. This should serve to minimize misunderstandings if someone leaves the practice during the course of a given year.

As an example, a group had a dispute which resulted in one doctor wanting to leave. All doctors thought that this event was covered by their buy-sell agreement. It was not and, in fact, only the triggering event of "death" through the payment of life insurance was covered. The parties had to negotiate through the departing doctor's buy-out which ended in costly and time consuming litigation. This situation could have been avoided with a properly designed buy-sell agreement.

Employment of Family Members

In certain situations, the employment of family member(s), e.g., an owner's spouse as office manager, in a co-ownership arrangement can work well. However, there do exist those situations where it does not work well. Employment of family member(s) always should be discussed prior to entering into any co-ownership arrangement.

The Fifth Option

Although there are basically four practice succession models, perhaps the fifth model would be to close your practice without selling it and walk away. This has happened recently where the retiring doctor got so discouraged over the difficulty in negotiations that the retiring doctor closed the practice. Although you probably won't be able to live for a long period of time from the practice sale proceeds, your practice can and should be a valuable asset and with proper time and effort, a well designed succession plan can be carried out.