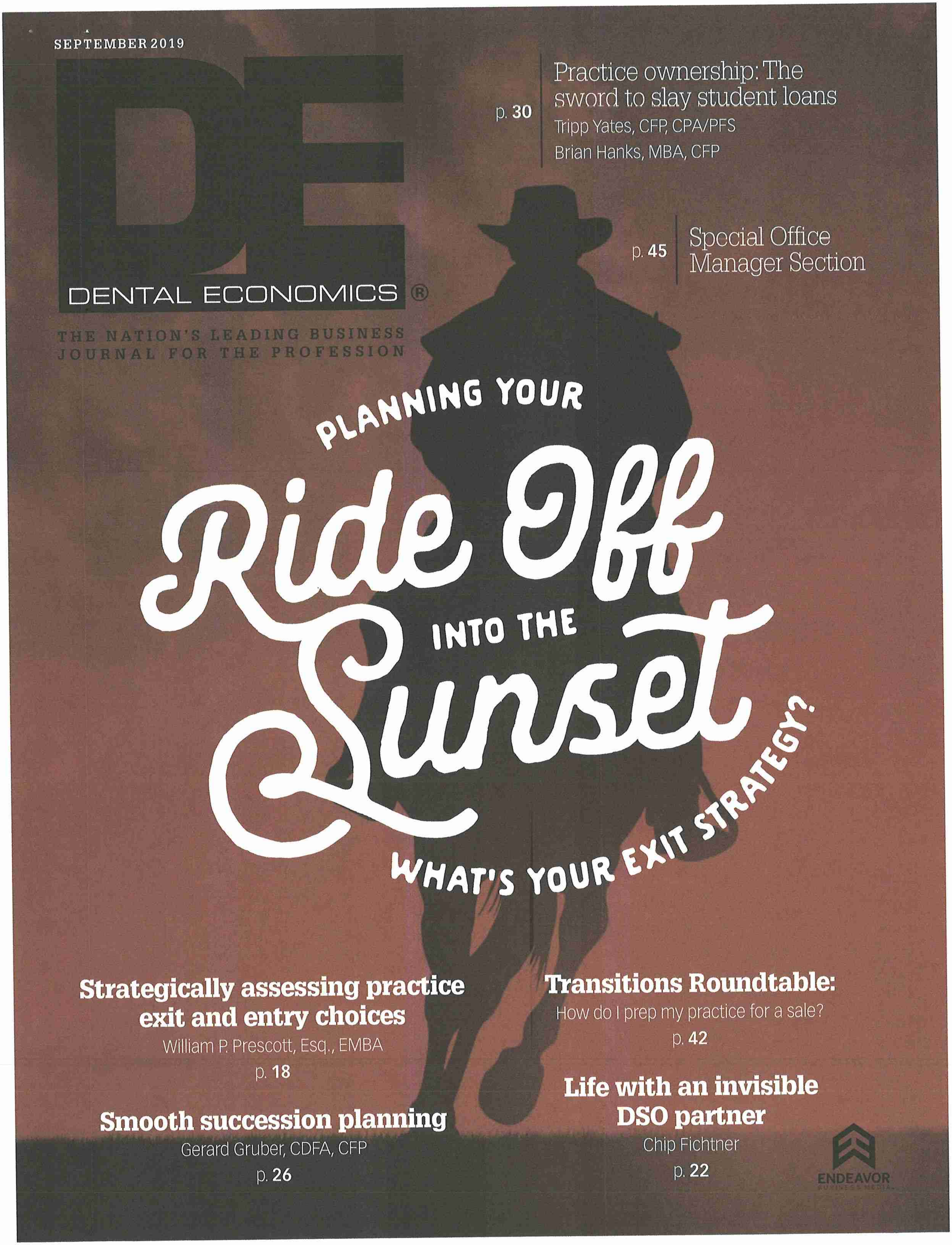

SEPTEMBER 2019

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DENTAL ECONOMICS ®

THE NATION'S LEADING BUSINESS JOURNAL FOR THE PROFESSION

PLANNING YOUR Ride Off INTO THE Sunset

WHAT'S YOUR EXIT STRATEGY?

ENDEAVOR

PART ONE

Strategically assessing practice exit and entry choices

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PLANNING YOUR PRACTICE EXIT and entry choice is crucial if you want to operate your practice your way throughout your career. If your practice is stable, you can grow it in a way that is consistent with your vision and ultimately depart when and how you choose to.

How you will eventually depart will dictate how you practice throughout your career, after you find the right practice opportunity for you. Hopefully, you will own or be an associate in a practice that allows you to provide quality services and remain passionate about your profession throughout your career.

But remember, if you don't own your practice, you cannot significantly fund your retirement plan and you cannot sell what you don't own. Worse yet, you will work for someone else.

COMPLETE SALE AND PURCHASE

A complete sale and purchase is simple. Except in very large practices, the practice owner can be paid in cash, and the tax treatment is favorable for both the seller and purchaser because asset treatment is attained. With asset treatment, the purchaser can deduct all assets purchased and the seller is taxed at primarily capital gains. A possible complexity is for practices operating as C corporations. These are double taxed unless an argument can be made for the use of personal goodwill, which is taxed at capital gains at one level. Advisors should follow the applicable case law.

Editor's note: This is the first of a three-part series that discusses one of the two common elements of strategic planning for dentists. This first article covers practice exit and entry choices, the second will cover risk management, and the third will discuss the necessity for strategic planning by dentists.

Typically, a selling dentist works in the practice postsale for some period of time and for a specified number of hours per week. Generally, the term of the postsale employment and hours per week is within the new owner's control.

The former owner will want the compensation to include both a productivity and administrative component. The former owner may want a provision that states that he or she will be scheduled much the same as before the sale. While the former owner may ask to be classified as an independent contractor, it is unlikely that he or she will pass the IRS, Department of Labor, or state tests to qualify as an independent contractor.

CO-OWNERSHIP AND PARTNERSHIP

Co-ownership and partnership are complex because there are three categories: the buy-in, the buy-out, and operations. While buy-in and buy-out categories are somewhat obvious, operations are not. Operations include allocation of compensation and overhead costs, decision-making control, and employment of family members as both doctors and staff. In addition, there are three business and tax structures: stock including goodwill, stock excluding goodwill, and the three-entity method.

There is a break-even point for the buy-in after the associate meets consistent performance standards. The associate does not incur a pay reduction to become an owner but can pay the purchase price within a measured period of time (e.g., not to exceed seven years).

The business and tax structure will dictate whether the purchase price will be increased or decreased to attain a tax-neutral fair-market value to balance the tax effects to the existing and new owners. For example, stock including goodwill is all capital gains to the existing owner and not deductible to the incoming owner. Therefore, the purchase price for the buy-in and formula for the future buy-out of the existing owner are decreased.

With stock excluding goodwill, the purchase price for the buy-in and formula for the future buy-out of the owner are increased. This is because the sale and purchase of goodwill is taxed as primarily ordinary income to the existing owner and should be increased again for an interest component. This primarily represents a pre-tax buy-in for the incoming owner due to the significant value of goodwill.

The three-entity method provides for asset treatment, so no increase or decrease to the tax-neutral fair market value is necessary. However, if the practice was formed before August 10, 1993, the anti-churning rules apply.[1] The anti-churning rules provide that the goodwill is not deductible for either the buy-in or the buy-out if there is more than 20% ownership of a third entity, or if the dentists are related (e.g., parent and son or daughter). Yes, the anti-churning rules still apply and not following them risks "audit roulette."[2]

Another challenge is that a junior owner may be unwilling to complete mandatory buy-out. In this case, the junior owner's employment should terminate, he or she should receive very little back for the buy-out, and the junior owner should be subject to restrictive covenants. Co-ownership agreements should always include dispute resolution provisions once equal ownership is attained. For very large and group prac-