Partnerships: Examining a Polarizing Business Model

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Current Practice Trends

Competition level is higher

- Doctors retiring later
- Growing number of dental school graduates

Dental School Graduates

- 12,210 applied; 4,871 were enrolled in 2010
- 4,873 graduates in 2010 compared to 3,778 in 1993
- 12 New Schools Coming Online
- Should Top 5,000 in Coming Years
Current Practice Trends

Actively Licensed Dentists
- From 166,383 in 2000 to 184,578 in 2010
- Increase of 18,195 or 10.94% in this decade

Current Practice Trends

Competition level is higher
- Doctors retiring later
- Growing number of dental school graduates
- Increased corporate presence
- Reduced demand from patients

Current Practice Trends

Increase in Group Practices
Perception VS. Reality

- **Negative Perception**
  - Seller will take a pay-cut
  - You can’t sell your remaining interest
  - They just don’t work

Real Benefits

- Reduce admin./mgmt. responsibilities
- Additional time off (Take a 2 week vacation)
- Lock in transition plan early
- Work as long as you like

Most Common Transition Plan

- **Full Sale (100%)**
  - Most doctors don’t want to quit “cold turkey”
  - Despite this, doctors typically choose 1 of 2 paths:
    1. Sell earlier than you would like
       - Income up/consistent
       - Feel/burnt out (temporary)
    2. Sell later than you should
       - Income declining
       - Overhead rising
       - Referring sources moving on
Selling the Cow & Keeping the Milk

**SITUATION:** Immediate Buy-Out w/ Post-Sale Employment
- Annual income of approx. $1M
- Overhead rate <45% (well below avg)
- Purchase price well above avg
- Seller wanted guaranteed post-sale employment for 10 yrs.
- Seller wanted $1,500 per diem with minimum 100 days per year ($150,000 per year minimum)

**PROBLEM:**
- Practice isn’t large enough for two full-time docs
- Buyer paying higher price for additional profitability that he/she isn’t getting

**SITUATION:** Delayed Buy-Out Preceded by Associateship
- Seller was 78 years old
- Income decreased each of last 10+ years
- A once efficient overhead rate now >80%
- Few remaining referring sources
- Resulting low fair market value
- Buyer wanted to “test drive” practice prior to acquisition

**WHAT HAPPENED:**
- Bank unwilling to finance the sale
- Unable to sell the practice

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**Alternative Transition Plan**

**Well Planned Partnership**
- Sell a fractional interest in your practice 3 to 10 years prior to your desired retirement
- Purchaser agrees to buy remaining interest at later date
- “Golden Handcuffs” (Security)
- Work as long as you choose
Prelude to a Partnership

- **Pre-Planning**
  - Facility/Capacity Considerations
  - Scheduling
  - Are you Partnership Material?
  - Sharing Management Responsibilities
  - Percentage to be Sold
    - Decision Making When Unequal ownership %

Relationship Failures

Why Do They Happen?

1. **Personality**
   - Acid Test
   - Professional Assessment

Associateships

Relationship Failures (continued)

2. Unforeseen
3. Unfulfilled Expectations
   - Financial Outcomes
   - Legal Arrangements
   - Process
Structuring the Buy-In

Decision to Proceed

Selection of a Transition Alternative

FMV and Proforma

Search for Candidate / Interviews

(A) Trigger Point
- Sufficient Collections
- No Decrease in Earnings

Employment Agreement

Buy-In Letter (Letter of Intent)

Note: 1 and 2 = Financial
3 and 4 = Initial Legal

Fractional Sale: Structuring the Buy-In

Fair Market Value (FMV)
- Most buyers/sellers feel this is the most important term
- Most emotional term
- Is my practice worth 70% of income?
- Other terms may have larger financial impact

Fractional Sale: Structuring the Buy-In

(A) Trigger Point
(B) Financial Structure

- Simultaneous Objectives
  - Affordable for Associate/Purchaser
  - Fair/Tax-Efficient for Owner/Seller
- Push/Pull in Tax Code

Solving Financial Structure: Two Alternatives

- Stock Sale (I)
- Asset Sale (II)

Alternative Financial Structure I: Stock Sale

- Ownership Conveyed by Stock Purchase
- Inherent Conflict
  - Taxed at Capital Gains Rate (20.0%)
  - Inefficient for Purchaser
Fractional Sale: Structuring the Buy-In

Alternative Financial Structure I: Stock Sale

- Best Scenario for Seller
  - Capital Gain (15% to 20%)
- Worst Scenario for Buyer
  - Can’t write-off stock
  - Exposure to existing liabilities (e.g. taxes, personal injury, creditor and other claims)

Can We Make This More Affordable?

- Assign Portion of Value to Stock (Tangible)
  - Tangible Component Typically Much Smaller
- Remainder Paid with Pre-Tax Earnings Shift (Intangible)

Stock Sale: Affordable and Fair

Fair Market Value

Tangible Net Worth

Intangible(s) Component

Stock

Pre-Tax Income Shift
Components of Value

Fractional Sale: Structuring the Buy-In

Alternative Financial Structure II: Asset Sale
- Two Sellers
  - Practice Sells Tangible
  - Doctor Sells Intangible

Asset Sale Structure

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Fractional Sale: Structuring the Buy-In

Asset Sale
- Majority of sale proceeds to seller taxed as capital gain (15% to 20%)
- Buyer Can:
  - Depreciate/Amortize (write-off) assets

Allocation of Purchase Price
- Order of Allocation:
  - Receivables
  - Consumable Supplies
  - Fixed Assets
  - Patient Records
  - Covenant Not to Compete
  - Personal Goodwill

Fractional Sale: Structuring the Buy-In
- Allocation of Purchase Price

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Tax Effects to Seller</th>
<th>Tax Effects to Buyer</th>
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<tbody>
<tr>
<td>Supplies</td>
<td>Ordinary</td>
<td>Expensed Immediately</td>
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<tr>
<td>Furniture &amp; Equipment</td>
<td>Ordinary</td>
<td>Section 179, Balance over 5 to 7 Years</td>
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<tr>
<td>Accounts Receivable</td>
<td>Ordinary</td>
<td>Collected Tax-Free up to Amount Allocated</td>
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<tr>
<td>Orthodontic Contracts</td>
<td>Capital Gain*</td>
<td>Amortizable Over 15 Years</td>
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<tr>
<td>Patient Files &amp; Records</td>
<td>Capital Gain*</td>
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<td>Leasehold Improvements</td>
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<tr>
<td>Corporate Goodwill</td>
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<tr>
<td>Personal Goodwill</td>
<td>Capital Gain</td>
<td>Amortizable Over 15 Years</td>
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</tbody>
</table>

*Although these items are capital assets, if retained in a C Corporation, they will be taxed at the corporation’s ordinary rate, and again when distributed to the shareholders.
**Fractional Sale: Structuring the Buy-In**

**Which Structure is Better?**
- Stock Sale with Management Fee
- Asset Sale with Three Entities

**Other Considerations:**
- Additional Costs of Asset Sales
- Related Party Transaction Rules
- What About My **Personal Expenses**?
- Buy-Out Considerations
  - Third Partner?

**Which Structure is Better?**
- Must Evaluate Both Options
  - Choose the Most Mutually Beneficial Option
C) Income Distribution

Fractional Sale: Structuring the Buy-In

(C) Income Distribution Formulae: Basic Types
(1) Equity (Ownership)
(2) Days Worked
(3) Multi-Tiered

Orthodontic Distribution Formula
Multi-Tier

<table>
<thead>
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<th>Days Worked</th>
<th>Productivity Diff.</th>
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<td>50.0%</td>
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100.0%
Orthodontic Distribution Formula
Productivity Differential

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<table>
<thead>
<tr>
<th>SELLER</th>
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<th>10%</th>
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<tr>
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Period of Productivity Differential Can Be Varied

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Fractional Sale: Structuring the Buy-In
(Will This Dog Hunt?)

**Proforma: Putting It All Together**
- Tests Financial Outcome
- Sets Target for Associate
- Illustrates Financial Structure
- Pre-Defines Distribution Formula

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Stepping over dollars to pick up pennies!

**SITUATION:** Buy-in following an Associateship
- 2-year associateship leading to buy-in
- To avoid the cost of professional services, the seller offered a "hand-shake deal"
- After 2 years, the seller proposed terms to the associate

**PROBLEM:**
- Neither seller or buyer knew what to expect
- The associate was shocked by the price and terms and backed out of the deal
- Seller back at square one