A Transition Primer: Financial, Legal, Business and Tax Ramifications

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There is a tremendous amount of information and disinformation out there about transitions planning and how it should be done. This memo is intended to provide an overview, or primer, on some of the significant issues that arise during the transition process.

We developed the term “transition” in dentistry, when we began the Mercer Transition Company in 1999. It was intended to describe the process of merging practices, incorporating new partners; or otherwise restructuring practices, in order to leverage their value and maximize the wealth in those practices.

Many practices have “trapped” or “hidden” wealth and the transition process is aimed at exposing and capitalizing on that wealth; in order to create greater freedom for the owners.

The process is most easily understood in three phases and this memo will discuss legal, tax, business and financial issues in the context of those three phases.

Phase One is, properly, a rigorous financial analysis and valuation of the practice. Too many deals begin with legal documentation, without understanding the numbers. It is crucial to conduct a fair market valuation (FMV) that is not based upon some random ratio of revenue; which fails to reflect profitability and other intangible factors. A proper valuation will be qualified under the Uniform Standards of Professional Appraisal Practice and the American Society of Appraisers. Such a valuation cannot and will not impact the compensation (such as a commission) of the valuation provider. This is the problem with most, if not all, broker valuations.

An equally important part of the Phase One work is a purchase feasibility analysis (PFA). This is a financial analysis of the practice numbers and designed to determine if the purchasing doctor(s) can cash-flow the purchase and, if so, how will it affect the purchaser and seller financially.

The valuation and PFA should be based upon conservative financial assumptions (e.g. discount and capitalization rates, marketability discounts, etc.) and the most credible market data.

Once the parties have clarity on the valuation and financial due diligence, we can move forward with Phase Two of the transition.

Phase Two is the “design” phase. During this phase of the planning we examine the tax issues of the partners/associates and practice. There are myriad tax issues in a properly designed transition; but one of the most basic, is the type of purchase: a stock purchase, or an asset purchase.

Both have advantages and disadvantages.

In a stock sale, the stock of the corporation that owns the practice is sold to the incoming owner/shareholder and the new partner/shareholders continue business as usual. A new shareholder's agreement will need to be drafted, or revised; but, otherwise, this is a very simple way to bring in a new owner.

The problem with this approach comes when we examine the tax consequences. The purchaser of stock in a corporation does not acquire deductible tax "basis". This is because the depreciable assets of the practice are owned by the corporation and not by the shareholders. Therefore, the corporation takes the depreciation deductions each year.

When the incoming owner/shareholder buys the stock he receives no depreciable write-off on that purchase.

The tax treatment of the seller is favorable; as he receives capital gain treatment (currently 20%) on the gain recognized.

In other words, the tax treatment on a stock sale is very one-sided and decidedly in favor of the seller.

In an asset sale, the practice sells the assets of the practice to the purchaser.

There are two kinds of assets in a dental practice: tangible and intangible. Tangible assets include dental equipment and technology, furniture and fixtures, computers, leasehold improvements, etc. Intangible assets are more popularly known as "goodwill". Goodwill describes your CV/resume, reputation, team, location, etc. In short, goodwill is all of the things that attract patients and cause them to purchase dentistry from you.

When a corporation (whether a C Corp or S Corp) owns the practice, it really owns the tangible assets. The goodwill is owned by the owner doctor, personally. This is an important point, because the selling doctor is selling goodwill, personally and also selling tangible assets from the corporation. The tax effect to both buyer and seller varies between these two classes of assets.

The sale of the personal goodwill will be recognized as capital gain to the seller. The purchase of goodwill is depreciated, evenly, by purchaser over a straight fifteen years.

The treatment of the tangible assets is a little more complex.

In an asset sale the purchaser DOES acquire depreciable basis; unlike in the stock sale. So this is a big positive. However, when the owner causes his corporation to sell the tangible assets, he triggers the recognition of depreciation recapture and he, typically, takes a big hit; in terms of recognizing ordinary income on the sale.

So, while an asset sale is better for the purchaser; it can be a negative for the seller.

Nevertheless, it is generally easier to balance the tax benefit/detriment to the parties by doing an asset sale and for this reason the vast majority of deals are designed as asset sales. There are also some creative ways to deal with the recapture issue to the seller and still maintain the win-win for purchaser.

None of these complications arise where the practice is a sole-proprietorship or partnership. The complications present themselves with corporations. Now, in the vast majority of states, dental practices can be organized as Limited Liability Companies (LLCs). LLCs provide all of the flexibility and freedom of a partnership; but with the limited liability protection of a corporation. Thus, LLCs have the benefit of corporations, without many of the regulatory requirements and tax complications.

LLCs are also much easier to transition. Where possible, all new practices will organize as LLCs.

Often, while we are dealing with the tax issues described above, we will take the opportunity to re-structure the practice as an LLC.

There are several other tax strategies that we employ in the transition context and which provide a huge win-win to both seller and purchaser(s). An example of this is the "management fee" technique. This requires certain structuring of seller's retirement plans and I have described this approach in earlier articles; but it allows for more rapid depreciation of goodwill by purchasers and allows seller to invest more of the proceeds into his retirement plan.

There are also some valuation issues that come into play, depending on whether the deal is structured as a stock sale, or an asset sale. If the valuation specialist is valuing the practice for a stock sale, the value will have to consider the non-deductibility of the purchase price to the buyer. A stock purchase will assume purchase of both the assets and the liabilities of the corporation; so that the buyer is taking on the debt, along with the assets. If the sale is an asset sale, it is done on a debt-free basis. In other words, only the assets are valued; the seller retains the debt.

There are many other issues that can arise in the design phase; but these are the ones that receive the most attention by other advisors; such as CPAs and attorneys.

During the design phase we will summarize the deal structure in a letter of intent (LOI). The purpose of the LOI is to lay out the issues and solutions in order to obtain general agreement from the parties. Once the issues and the reasoning for the structure have been discussed, the parties will initial the LOI and we will move forward with Phase Three.

We always coordinate with the clients' advisors and make sure that we are on the same page before going forward with Phase Three.

Phase Three involves the drafting of the formal purchase and transition documents. These may include the purchase agreement, partnership agreement and various other transition documents.

These documents may be reviewed by local counsel; but they normally require very few changes.

Conclusion: Hopefully, this primer has been helpful in providing an overview of some of the major issues involved in the transition process. Please let us know if there are more specific business, legal/entity, or tax issues of concern to you; we have probably written an article on the subject. Many of these articles are on our web site; but we are happy to forward them to you on request.