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Ready ... Set ... Retire!

In Part 2 of their series on retirement exit strategies, the authors share how to create proper buy/sell contracts.

Aristotle once said that one should work with virtue to obtain the material result of one's work for a lifetime. Almost all dentists perform their work with virtue, yet many haven't accumulated enough "material result" to retire when they choose. Today's dentists need more cash for retirement; they also realize less profit from a practice sale than did their predecessors. Nevertheless, dentists today can enjoy a long and financially comfortable retirement by employing an indispensable planning tool: an exit strategy.

In Part one of our series, we explained three critical steps in creating an exit strategy:

❶ Increase your practice's cash flow to meet your current financial needs. When you're free of immediate financial worries, increase cash flow to fund your retirement fully.

❷ Calculate how much money you'll need in retirement to meet your needs.

❸ Determine which pension plans and investments will help you achieve your financial goals.

These steps address living well now *and* fully funding your retirement. The fourth step of an exit strategy is identify-

ing your successor and entering into appropriate contracts.

If Dr. John Smith is considering retirement, these are his typical options: to completely sell the practice and retire; hire an associate and later sell the practice to him or her; sell a portion of the practice in a solo-group arrangement, with each dentist's practice remaining separately owned; or later make the associate a co-owning partner in the practice. If finding a suitable candidate proves impossible, Dr. Smith's fifth option may be to work a little longer, then close the practice. If Dr. Smith wants to work longer, both the solo-group and co-ownership models allow him to continue practicing. The more time he allows prior to retirement, the more options he will have. This is why dentists should develop an exit strategy *at least* 15 years prior to retirement.

No matter what transition option,Dr. Smith and his successor must agree on the purchase price and the terms and structure of the sale and acquisition. Note that practices formerly sold for approximately 65 percent of annual gross collections. In May 1999, these values began dropping to approximately 55 percent after negotiations — and continue to do so. More dentists are leaving than entering the profession, a trend expected to intensify as baby-boomer dentists retire.

Practices with healthy profitability, however, sell for higher values than those without effective management systems for healthy cash flow. Therefore, it is wise to increase the value of your practice before attempting to sell it.

Practice-management training is invaluable while you practice and when you sell. Dentists who become effective managers and leaders enjoy dramatic increases in hourly production, decreased work hours, improvements in patient care and service, and reduced stress and staff conflicts. Should the value of your practice continue on a downward trend, re-evaluate and strengthen practice management to increase your production. Dentists must actively assume leadership of their practices; it's foolhardy to expect staff, spouses, or consultants to repair the neglect.

While improving your operation to attract potential buyers, you must select the transition that works best for you. Let's examine each option.

New law may affect dental practice sales

The final rules were issued April 14, 2001 for the 1996 Health Insurance Portability and Accountability Act, commonly known as "HIPAA," which will take effect in both 2003 and 2004. In their current form, the new rules would require practice owners to take measures, perhaps in a letter of intent and/or as a representation and warranty in the sale and acquisition documents, to ensure that a potential purchaser of a dental practice acts in accordance with HIPPA's privacy and consent standards prior to reviewing patient charts or receiving the patient records in a practice sale. We will keep you informed on this important topic as matters progress.

— *Dr. James Pride and William Prescott*

The complete sale

This is the simplest form of practice succession: You locate a purchaser, sell the practice — hopefully for cash — and retire.

Dental practices are generally sold through either an asset sale or stock sale. With either method, the seller attempts to obtain as much cash as possible at a relatively low capital-gains tax rate, thus avoiding higher corporate or personal taxes. The purchaser wants tax deductibility and shorter vs. longer write-off periods for the practice acquired.

The complete sale does have a few caveats.

For the seller:

⇨ The purchaser could default on a seller-assisted loan.

For the purchaser:

⇨ Risks losing the acquired goodwill should the senior doctor fail to transition patients to the new practice.

⇨ Should ensure that the price paid for the practice is reduced to reflect "buying power" in after-tax dollars.

⇨ If the CPA fails to completely and accurately project the cash flow, the purchaser can default on payments for the practice loan.

For both parties:

⇨ Each could suffer if the purchase price is too high, which could lead to the purchaser's default.

The asset sale

In an asset sale, the purchaser acquires all or part of the seller's assets without assuming any of the seller's liabilities — debts on dental equipment or expansion loans, for example. Purchasers like asset transactions because they're not acquiring liabilities, and they can write-off the acquired assets, which they cannot do when buying stock. The buyer can depreciate the acquired dental equipment over seven years and the acquired "goodwill" over 15 years. Goodwill represents all of the benefits derived from the distinctive location, trade name, credit rating, reputation, and patronage of the business. Patronage is the most important aspect of goodwill. Sellers usually place a value on goodwill and consider it

as one of the assets. An asset sale can benefit the seller, because you receive capital gains on the goodwill, which typically comprises the biggest part of the sale; therefore, you pay a lower tax rate. However, if your practice operates as a C-corporation, the sale of assets results in a double tax: 35 percent at the corporate level and capital gains rates at the shareholder level. This double taxation is a significant problem for the seller.

Because of the outcome of two tax cases in 1998 (*Martin Ice Cream Co. v. Commissioner, 1989* and *Norwalk v. Commissioner, 1998*), goodwill can be considered "personal" to the shareholder/doctor under certain circumstances and therefore is not subject to the practice's corporate taxes.

Although still an open question for tax purposes, if the goodwill is a personal and not a corporate asset, then the seller can arguably avoid the double tax on the sale of the C-corporation's assets. This double-tax problem can also be avoided through handling the practice transition as a stock sale rather than an asset sale.

Stock sale

If your practice operates as a corporate entity, you can opt to structure the transaction as a stock sale. This helps to avoid double taxation of the asset sale; taxation occurs at the lower capital gains rate for selling stock. However, purchasers will be disinclined to acquire "stock" because this type of transaction does not allow for the write-off of assets; it could also subject the purchaser to the liabilities of the professional corporation.

Minimize this problem for the purchaser by:

⇨ Agreeing to "hold harmless" or "indemnify" the buyer from any actual or potential liability of the corporation prior to the sale

⇨ Reducing the selling price to reflect the tax detriment to the purchaser

Your key to securing a successful transition is careful planning. Do not hesitate. Develop your exit strategy *today*.

Financing the purchase

Request the purchase price for a complete sale in cash. Allowing the buyer to pay by installments earns interest for the seller and extends the taxes paid on the proceeds over time; however, there is a risk of default. If you finance any part of the practice purchase, be sure to insist on the same security as any other lender. Also insist on having the first lien on all practice assets and accounts receivable of the purchaser's practice ahead of any other lender.

An asset sale requires an asset purchase agreement, while a stock sale requires a stock purchase agreement. Both documents should contain provisions dealing with the date of the sale and purchase, determination and payment of the purchase price, indemnification/hold harmless clauses, representations and warranties, and rework and noncompetition agreements. Spelling out the details of the arrangement will prevent potential disputes later.

For these agreements to work, the practice appraisal, purchase price, and other contract provisions must be equitable to both seller and buyer. If you have any misgivings, air and resolve them *before* signing.

Hire associate with later sale

This method is similar to a complete sale, only the purchaser is first hired as an associate, usually for one to five years prior to the owner's retirement.

The reasons for employing the purchaser as an associate first include: the practice is growing; the seller wants to work less but not retire immediately; and the practice provides a high level of professional services requiring a lengthy training period for the incoming doctor. This transaction has its own caveats:

For the seller:

⇨ Risks the purchaser backing out of the acquisition

For the purchaser:

⇨ May overpay for the practice if the purchase price is determined by a flawed formula, creating a risk of default

In this scenario, the associate signs two agreements at the outset: the employment agreement, which provides for the incoming doctor's schedule, compensation and bonuses, fringe and other benefits, payment of expenses, nondisclosure/noncompetition promises, time off, and termination of employment; and the asset purchase agreement and related documents pertaining to the buy-out of the practice.

The sale takes place upon the earliest of a specified event, usually a retirement date or the death or permanent disability of the practice owner. Since the practice will be purchased at a later date, the purchase price is not set at a definite amount; rather, it is determined by a formula based upon future revenues and profits.

These arrangements usually work well; however, if the purchase date is too distant, the seller has an increased risk of the buyer changing his or her mind.

Solo-group arrangement

In a solo-group, each doctor operates a practice as a sep-

arate entity under an office-sharing agreement. The solo-group model shares expenses, and possibly some staff, without the complexities of co-ownership. If you aren't ready to retire, but are sufficiently busy to hire and keep an associate productive, then the solo-group may be beneficial.

Some caveats to the solo-group arrangement include:

For the seller:

⇨ Still leaves open the problem of later finding a third doctor for the buy-out of your practice.

For the incoming doctor:

⇨ May be required to pay half the expenses before producing half the revenue.

For both parties:

⇨ Complexities in paying salaries and making retirement plan contributions for common employees.

⇨ If one party buys out the other, complexities arise when one practice entity differs from the other, e.g., C-corporation vs. sole proprietor.

The solo-group is meant to be a *permanent* arrangement, one with advantages to seller and purchaser. The owner-dentist of a busy practice sells to an incoming associate the opportunity to develop a patient base and to build a practice within a practice. In this arrangement the owner and associate should have the desire and compatibility to work together long-term. By attaining certain predetermined productivity goals over a measured period — two to three years — the associate acquires the goodwill of his or her "developing patient base" and an undivided interest in the tangible assets of the practice.

Note that the senior dentist has not sold the practice to the associate, but has helped the incoming dentist build a second thriving practice where only one existed before. This gives the senior dentist the opportunity to make another sale later — the sale of the intact practice upon retirement to another doctor.

The solo-group option gives the original owner the opportunity for greater financial return. The associate also benefits from establishing a practice under the security of a mentor. Upon the death or permanent disability of an owner, the remaining owner is usually required to buy the other's practice.

These involuntary events are often funded through insurance. Upon one owner's retirement, the remaining owner(s) is usually not obligated, but has the option to acquire the practice of the retiring doctor. The reason is that the nonretiring owner usually has no need to acquire the second practice after building his or her own practice.

The younger doctor usually has no obligation to buy out the retiring one in a solo-group arrangement, making it a better option than co-ownership. In a co-ownership agreement, the younger partner must buy out the retiring member, causing succession problems which result in the failure of many co-owned practices.

Co-ownership

Co-ownership is the most complex form of succession due to the difficulty in getting all owners to agree on things. The areas which owners must agree upon are: allocation of compensation, bonuses, fringe benefits and retirement plan contributions, decision-making and voting control, disputes resolution, admission of new owner(s), and buy-out of a departing owner. These complexities make it difficult to keep groups together. Groups that endure do so because of effective communication.

Co-ownership has its own caveats:

For the seller:

⇨ The incoming doctor may be unwilling to eventually buy out the senior doctor's interest.

For the purchaser:

⇨ The senior doctor may be reluctant to relinquish control.

⇨ The senior doctor's spouse may also interfere with practice operations.

For both parties:

⇨ Disagreements can occur over expense allocations.

⇨ Complexities in decision-making.

⇨ Each owner may have different goals relative to retirement plan contributions.

It would take a separate article to cover properly the intricacies of this complex practice arrangement. We do not usually recommend co-ownership for the general dental practice.

A fifth option

Some dentists close their practices without selling them. One retiring doctor was so discouraged over the difficulty of negotiating a practice sale that he closed the doors instead. Because purchasers will be harder to find in the future, we expect to see more of this.

To avoid such an unfortunate situation, we urgently recommend that you:

❑ Plan well in advance for your succession.

❑ Employ the best practice-management techniques to develop a well-run, marketable practice.

❑ Fully fund your retirement (see Part One of this article) so that you will not have to depend on the practice sale to live.

Your key to securing a successful transition is careful planning. Do not hesitate. Develop your exit strategy today.

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For more information on developing your transition plan and to enroll in Pride Institute's popular new seminar, EXIT STRATEGIES ™, call (800) 925-2600. Mr. Prescott can be reached at (440) 246-5288.