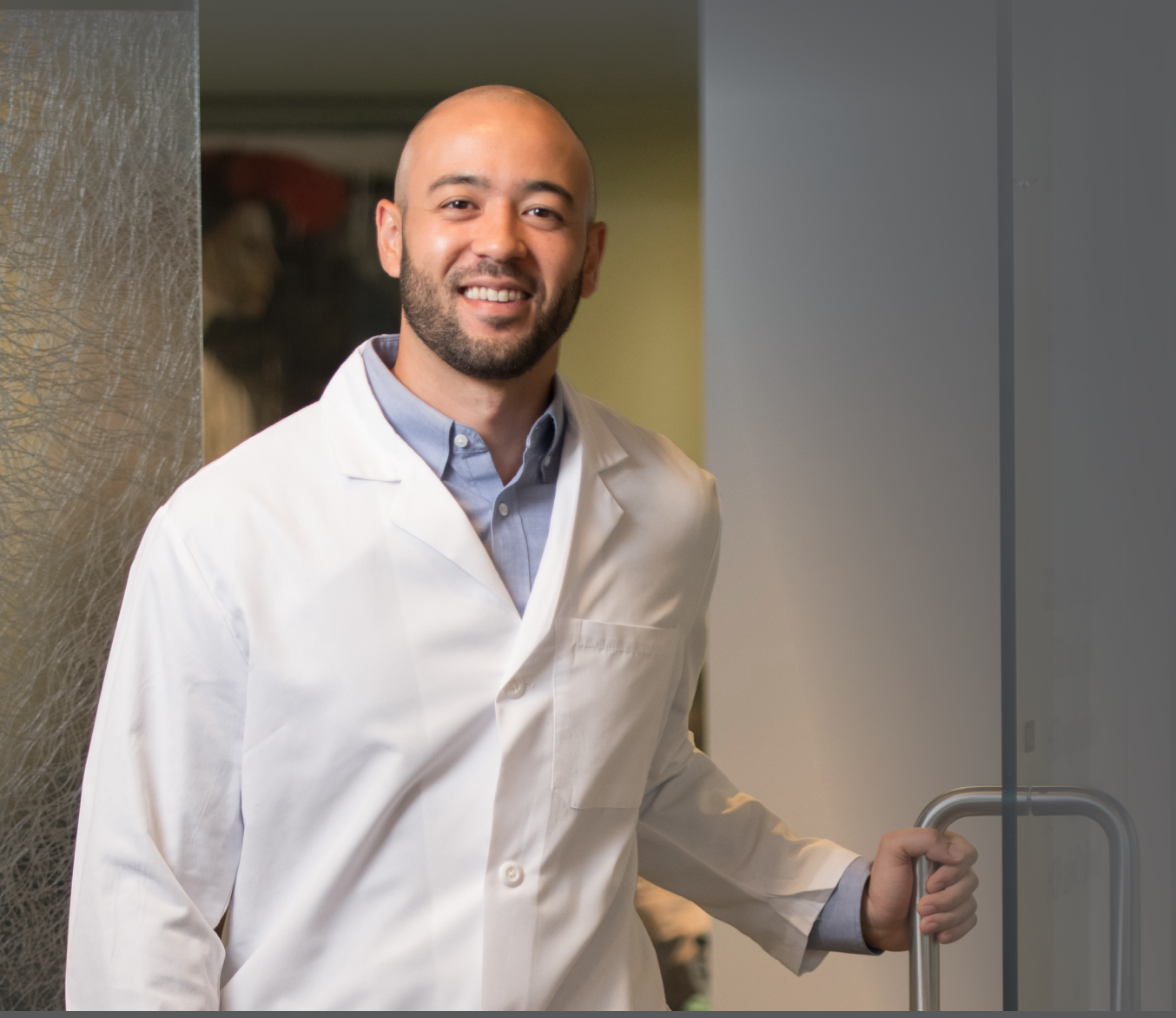
Joining and Leaving the Dental Practice

THIRD EDITION

William P. Prescott, Esq., M.B.A.-Executive Program



ADA Center for Professional Success™

Wickens Herzer Panza • 35765 Chester Road • Avon, OH 44011
Phone 440.695.8067 • Cell 440.320.8984 • Fax 440.695.8098
WPrescott@WickensLaw.com • www.PrescottDentalLaw.com

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THIS BOOK IS NOT INTENDED TO PROVIDE SPECIFIC LEGAL OR TAX ADVICE

This book is not intended to provide specific legal or tax advice. For specific solutions to legal and tax matters, please consult with your legal counsel and CPA.

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JOINING AND LEAVING THE DENTAL PRACTICE
THIRD EDITION

PREFACE

Joining and Leaving the Dental Practice, Third Edition, is the updated first half of the Third Edition of *Business, Legal, And Tax Planning for the Dental Practice*.

The purpose of *Joining and Leaving the Dental Practice* is to educate you, your spouse, and advisors on all important business, legal, and tax planning issues relative to your practice succession or entry choices. This book recognizes that in any form of practice transition, you have a silent partner, the IRS, specifically in the complex area of group practice discussed in Chapter 12.

A friend once jokingly suggested that I write a book titled “Nothing But the Tooth!”. Maybe this is as close as I get to it.

Please enjoy and provide me with your comments, questions, and suggestions.

As always, I am grateful for my wife Mary Lou being here.

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Chapter 1

READY, SET, RETIRE!

Your new dream is to now get out of practice or get help through an associate. You're getting worn out, and you see a changing patient demographic in clinics all around you that advertise on television and through other media. What are the issues to consider, what are your choices, and how do you make a significant lifestyle change with minimum stress? Making such a significant decision usually takes about 2 years. Why is this important? Because when I teach exit strategies, less than 5% of attendees have an actual plan. And that means you probably have no strategic plan for profitable practice operations. But don't feel bad, the same percentage of lawyers and accountants also have no plan.

Planning Issues

Figure 1-1 is a checklist of issues in question form that you need to address before selecting and evaluating your exit choices. While the checklist is somewhat self-explanatory, the biggest questions I am asked are "can I afford to retire?" and "what will I do with my time?" However, because continued coverage is essential, "will we have quality health care coverage after retirement?" is quickly climbing up the list. Make sure that you understand your reasons for retirement. If you want to retire because your practice has you "burned out," practice management help is available.

Authorize Preparation of the Practice Valuation

Irrespective of your exit choice, timeline for retirement, or the possibility of your death or disability, you need to know what your practice is worth. In the years prior to retirement, you cannot increase your practice's value unless you know its current value. Once they are initially prepared, valuation reports can be easily updated yearly. Of the 30 factors listed in Figure 5-1, Practice Profile Factors for Selection of Capitalization and Goodwill Rates, the most significant are collections per year and owner profit percentage. With a prepared valuation report, both of these items can be monitored and improved over time. Your advisory team can refer you to an experienced dental appraiser if your existing team members do not prepare appraisals.

Authorize a Systems Review and Prepare Monthly Financial Statements/Meet with Your Advisory Team Regularly

Your management consultant can be engaged to review, update, and implement your practice systems to increase practice value. Additionally, your certified public accountant (CPA) should be preparing monthly, or at least quarterly, financial statements with meaningful expense and profit categories. The CPA and management consultant should coordinate on the expense and profit line items. You should meet with your accountant twice and attorney once each year to review the operations, update your succession plan, and implement year-end planning.

Locate Your Successor

Your candidate search is dependent on your exit choice. Unless you have made an exit choice, you do not know for whom you are looking. How do you find your successor? Using the services of a broker has become very predominant, mostly in general practices, where the complete purchase and sale of the practice is undertaken typically in exchange for 10% of the selling price.

I know of brokers in orthodontics and endodontics; however, I have not found any in other specialties. *The Journal of the American Dental Association (JADA)*, as well as the journals of state and local dental societies include advertising pages, or such ads may be found on their websites. The American Association of Orthodontists (AAO) now maintains a listing service so practice sellers and associates can find each other. Dental schools usually have a dean, a clinical director or another professional who can pass on your name to students, residents, or former graduates who might be interested in becoming your successor. Finally, dental equipment and supply companies maintain up-to-date information on available candidates. Before interviewing any candidate, carefully consider the interview process, and ask the candidate to sign a confidentiality letter and a release to investigate references.

Authorize Preparation of a Letter of Understanding or Intent

The letter of understanding, or letter of intent, delineates all relevant terms of the exit choice. This is as much for your and your advisory team's benefit as it is for your successor candidate and his or her advisors. If your exit choice is not in writing, it probably won't work well.

Authorize Preparation of Agreements, Especially for Co-ownership or Partnership

Agreements are prepared from the letter of understanding or intent. Particularly with a partnership, the agreements should be prepared before the incoming dentist even picks up a handpiece. Dealing with the buy-in, buy-out, profit allocations, and decision-making control after thedentist starts will only lead to later disagreements. I sometimes hear "if this person does not work out, I will have paid unnecessary advisory fees." Not only does preparation of the agreements help ensure the success of the transaction, if the exit choice is the right one, the identity of the candidate will not matter. If one candidate doesn't join you, you will simply look to another candidate.

Don't Forget the Real Estate

The general rule is if you are no longer an owner of your practice, you no longer need the real estate. Although there are exceptions and receipt of rent may be desirable to you, because a tenant could potentially move and leave you with an empty facility, you should probably dispose of your practice real estate or your interest in it once you leave the practice. On the other hand, if your practice is not the only tenant in the facility or the best use of the space, you can retain the real estate and sell it when you choose. Given the recent turmoil in real estate, a minimal price might be offered. The purchaser may rent with an option to purchase that becomes a mandatory purchase at some specified time. You should stay away from traditional rights of first refusal for your real estate or practice because it is difficult, if not impossible, to obtain a legitimate third-party offer when a right of first refusal has been granted. However, a modified right of first refusal works well. When you are ready to sell, you notify the purchasing dentist or specialist. The definition of fair market value and appraisal methodology would be the same process as for an option to purchase the real estate, with a limited period of time for your successor to decide whether to purchase or not. As an alternative, if you decide to sell the real estate, your successor may have the option to match the third-party offer for a limited time period. If the real estate is sold to a third party, the sale would be subject to the practice purchaser's lease and any renewal options.

Seller Due Diligence

You need to know all you can about your successor. Upon retirement, every dentist and specialist should want the best possible care for his or her patients. If a successor candidate's practice philosophy, work ethic, and technical abilities are inconsistent with yours, there may be some problems. This phase of seller homework is called due diligence.

If you are providing financing for any portion of the purchase price, you need to ensure your payment. In addition, you will need to know the incoming doctor well. And if the incoming dentist or specialist will be joining your practice as an associate, you may wish to know a little bit about that person prior to working together, possibly through an initial apprenticeship. Putting energy and effort into the interview process can save you much grief, money, and time by finding the "right" candidate to succeed you.

End Your Career Your Way

A complete purchase and sale is the least complex way to end your career. You are paid in cash and get fair market value for your practice and goodwill. If you have identified your successor and are significantly busy, admitting an associate with a complete sale in 1 to 3 years is workable. A solo group arrangement option generally works better than group practice because your successor may not want to purchase the second half of the practice (See Chapter 12). A merger can work well for an otherwise unsalable practice. You can also work for an additional 1 or 2 years and then walk away. Although more complex than a complete purchase and sale, if you plan to practice full-time for 7 or more years, co-ownership can work as long as Dr. Junior is willing to purchase the second half of your practice on a mandatory basis.

Summary

If you want to retire, can afford to retire, know what you will do with your time, and have selected your exit choice, you are ready to go once your successor is located. Make sure, however, that you maintain health care coverage for you and your spouse.

Assemble your advisory team and understand how members are paid. Is the attorney and/or CPA you selected licensed to practice in your state? If not, local counsel and/or a CPA should be engaged as part of the advisory team. Your advisory team should consult with you on the best exit choice in your situation. You should authorize preparation of the practice valuation with an experienced dental appraiser. Your advisory team should know who can provide the systems review. You should authorize preparation of meaningful accounting reports by your CPA, as well as schedule a series of meetings with your advisory team in person, via telephone, or via video conference. Once you delineate your exit choice, your successor needs to be located and interviewed. You need to authorize preparation of the letter of understanding prior to preparation of detailed agreements, especially for co-ownership. And don't forget the real estate. I hope this map helps!

Figure 1-1

EXIT CHOICE QUESTIONS

1. When do I want to retire?
2. Can I afford to retire?
3. Is my retirement complete, or will I continue to practice part-time?
4. What will I do with my time?
5. Do we have a financial plan in place?
6. Have we adjusted my financial plan to account for retirement and a reduction of income?
7. What is our health status?
8. Will we have quality health care coverage after retirement?
9. Why do I want to retire?
10. Have our wills, powers of attorney, and estate plans been updated?

Chapter 2

EXIT CHOICES

If you have sufficient savings, know how you will spend your time, and you want to retire, here are the choices: a complete sale, hiring an associate with plans for a later sale, co-ownership, a solo group arrangement, a merger, or simply walking away.

Complete Sale

A complete sale is simple as compared to other exit choices, with the exception of just closing the doors. Unlike 20 plus years ago, you should be fully paid in cash at closing. For large practices with annual collections of more than $1,000,000, there may be a component of seller financing of up to 20% of the selling price.

Depending on the size of your practice, your continued employment by the purchaser may be necessary to transfer your goodwill, finish cases, and provide treatment as requested by the purchaser for an agreed-upon time period, typically 6 months to 1 year and by mutual agreement thereafter. You should be paid the greater of a daily or half-day rate or an agreed-upon percentage of production or collections, often 35% for a general dentist and higher for specialists. The daily rate accounts for greeting patients and administrative time and ensures that if you work, you will be paid irrespective of your treatment schedule. While laboratory costs should be paid by the purchaser's practice, your direct business expenses, insurances, and benefits not paid by the purchaser's practice would be reduced and offset from your compensation calculation. Although you and the purchaser would prefer that you are classified as an independent contractor for expense deduction purposes, you are an employee.[1]

In the past several years, corporate practices of all types have become common and are providing sellers with the ability to sell. If you are selling to a corporation, demand full payment at closing, without any hold back based on future practice performance. Do not accept stock as payment for any part of the purchase price. Make sure that continued employment after the closing is not a requirement for full payment.

Hiring an Associate with a Later Sale

If you plan to leave within 5 to 7 years, do not enter into a partnership; it will take the new owner 5 to 7 years to pay for the first half of the practice. Rather, hire an associate with an agreement for a later complete sale. With this choice, you and the associate sign the associate employment agreement, the purchase and sale agreements, and your post-closing employment agreement. The signed purchase and sale agreements close 1 to 3 years from the date of the associate's employment or earlier if your death, disability, or election to retire occur.

For example, the associate works for you for 3 or 4 years, then you work for the associate by mutual agreement thereafter. If the new owner terminates your employment for no reason, your

[1] Prescott WP. Legislation Affecting Your Practice. *Dent Econ*. September 2011; 101(9): 100-101; Prescott WP, Altieri MP, VanDenHaute KA, Tietz RI. Worker Classification Issues: Generally and in Professional Practices. *The Practical Tax Lawyer.* Winter 2017; 36(2): 17-28; Prescott WP. Worker classification - A continuing problem. *Dent Econ.* 2017; 107(10): 28,30,32-33.

restrictive covenant becomes null and void. Similarly, if you do not sell your practice under the terms of the agreement, the associate's restrictive covenant becomes null and void. See Chapter 10 for more information on restrictive covenants.

To justify taking your practice off the market by such an arrangement, require an earnest money deposit in the form of a promissory note in an agreed-upon sum. Except for specified reasons, if the associate does not purchase your practice, the promissory note becomes immediately due and payable. You will also be subject to a comparable promissory note that would become immediately due and payable should you decide not to sell your practice. An earnest money deposit as a promissory note may be helpful to an associate if the associate is not able to make a significant deposit.

If 100% financing is not available in the future, despite the purchaser's "best efforts" to obtain it, either the obligation to purchase your practice becomes void or the terms of owner financing delineated in the agreement go into effect, or if not present are addressed as an addendum.

As to the determination of the purchase price, your practice is valued as of a date before the associate's employment begins. It is again valued 1 year after the associate has begun employment. The rationale is that in 1 year, the associate's production is attributable to your patient demand. If the associate grew up in the community where your practice is located, those patients directly attributable to the associate can be excluded from the goodwill calculation. However, the number of patients directly referred to your practice by the associate will probably not be significant. The purchase of new equipment and technology during the associate period should be as mutually agreed upon over a threshold dollar amount, except for emergency purchases, and are depreciated over a 10-year straight-line basis. For example, if, at the end of year 1 of an associate period that will last 3 years, you and the associate agree to purchase technology that costs $40,000, the purchase price for the technology will be reduced by $4,000 in year 2 and $4,000 in year 3. The fair market value will be $32,000.

What's beneficial about hiring an associate with a later complete sale plan is that there is one and not two owners. More importantly, unlike a partnership, there is asset treatment, which means that you receive mainly capital gains, are paid in cash, and the purchaser can deduct the full purchase price. The exception is a son or daughter where the practice was formed prior to August 10, 1993, and the goodwill is not deductible due to anti-churning rules.[2]

Partnership or Co-ownership

Partnership or co-ownership is the most complex form of practice ownership. Associate buy-in(s), owner buy-out(s), and operations (consisting of compensation allocations, decision-making control, and employment of family members as dentists/specialists and/or non-doctor staff) are involved. Added to this complexity, there are three business and tax structures for co-ownership, two of which do not work well if the tax rules are followed.[3]

[2] Internal Revenue Code Section 197(f)(9); Prescott WP. Exit Choices. *Dent Econ.* 2015; 105(1): 56-58.

[3] Prescott WP. Co-ownership in Dental Practices: It's Taxing. *The Practical Tax Lawyer*. Summer 2012; 26: 7-10. Prescott WP. Co-ownership — a taxing relationship. *Dent Econ*. September 2010; 100(9): 82,84,116.

Solo Group Arrangements

Solo group arrangements are a good alternative to co-ownership because the associate who purchases the first half of the practice is not obligated to purchase the second half. Because you and the associate, now an owner, have separate practices, you sell your practice at retirement to a third dentist. In a solo group arrangement, you sell one-half of or an undivided interest in all tangible assets and goodwill. Thereafter, the practice owner and the new owner, your former associate, operate each practice under an office-sharing agreement. Common expenses to both practices are either equally allocated or allocated on the basis of respective productivity. A solo group resolves the problem of non-deductibility of assets in partnership to achieve favorable asset treatment for both the seller and purchaser. The exception is for family members if the practice was formed prior to August 10, 1993.

Merger

If your practice is relatively small or unsalable for any reason, you can merge your practice into a larger practice with adequate space. You can continue to work and when you're ready to retire, the purchaser's practice purchases your patients under a 12-month agreement. The selling price is often 35% of the purchasing practice's collections attributable to your goodwill or revenue generated from your patients. The purchasing practice pays only for your goodwill actually transferred. There may be an initial payment upon your retirement, often half of the anticipated or calculated goodwill value, with the second half "trued-up" 12 months after the sale. Usually the purchasing owner does not need any of your equipment, even specified items. One reason mergers are becoming common is new dentists often cannot afford to purchase a small practice without having another job, and they will not take the risk of not receiving the benefits of what is paid for.

Walk Away

Assuming that you can afford to retire, you can elect to work 1 or 2 years longer than anticipated and then close the doors. As an example, your practice collects $800,000 in a year. Your earnings are $320,000 or 40% of collections. By working 2 more years, you earn $640,000 (maybe $500,000 if you take more time off). If your practice sells for 65% of 1 year's collections, or $520,000, you haven't lost anything. See the example in Figure 2-1. If a successor is available when you are ready to leave, you sell. If not, you walk away.

Some specialists and general dentists in certain geographic areas have no choice other than to close the doors should a successor not be available. In this instance, although you are not being paid for your practice, you are not faced with the complexity of selling it.

Summary

A complete purchase and sale is the least complex option for exiting a practice. You get fair market value for your practice and goodwill and are paid in cash with possibly a small percentage of seller financing. Although more complex than a complete purchase and sale, if you have identified your successor and are sufficiently busy, admitting an associate with plans for a complete sale in 1 to 3 years is a workable option. If you plan to practice full time for 7 or more years, co-ownership can work as long as Dr. Junior is willing to purchase the second half of your practice. A solo group arrangement often works better than co-ownership in the event Dr. Junior does not want the obligation of purchasing the second half of your practice. A merger can work

well for an otherwise unsalable practice. Finally, you can work an additional 1 or 2 years and walk away. You have to pick one!

Figure 2-1

WALK-AWAY ANALYSIS

1.	Revenue	$ 800,000
2.	Owner Profit of 40%	$ 320,000
3.	Work 2 Years	x 2
4.	Estimated 2 Years' Income	$ 640,000
5.	Work Less? ..... Estimated	$ 500,000
6.	Sell Practice at 65% of Revenue	$ 520,000

Which Alternative Looks Better?

Chapter 3

ENTERING PRACTICE — MAKE THE FIRST CHOICE THE RIGHT CHOICE

Your practice entry choices are as follows: establish a practice, purchase a practice immediately, become an associate and then purchase the practice in 1 to 3 years, become an associate and later be elevated to a co-owner, become an associate and enter into a solo group arrangement, or become a permanent associate.

Practice Option Report

When considering alternative options, prepare an analysis in light of your personal goals and financial situation. The “Practice Option Report” in Figures 3-1 and 3-2 provides an analysis of the qualitative and quantitative factors for each option.

Qualitative Considerations

The qualitative portion of the Practice Option Report should consider your goals and practice objectives in terms of the following categories (Figure 3-1): (a) the demographics of the patients you wish to attract (income, age, etc.); (b) the method of payment you expect for your rendering of professional services (fee for service, insurance, managed care, etc.); (c) the mix of procedures that you expect to perform; (d) the geographic area where you intend to practice; (e) the geographic area where you intend to live; (f) the form of practice in which you intend to operate (establish a practice, acquire a practice, acquire a portion of a practice/practice merger, operate in a shared solo-facility format, or become an associate); (g) a statement of your mission practice philosophy; (h) a statement of your commitment to continuing education; (i) a statement of your commitment to learning the business of dentistry or your specialty; (j) the characteristics of the practice, its assets, and the facility that you intend to operate from (size of the facility, whether you will rent or own your building, the number of treatment rooms, revenues per year, the number of hours that you intend to work per week, etc.); (k) a statement of your dedication to community involvement; (l) a statement of your personal and family objectives; (m) any other category that you deem relevant; and (n) available opportunities. Your goals for entering practice may be limited by available opportunities in the geographic area where you want to live and practice. This does not mean that you need to give up and compromise; you just need to watch and wait.

Quantitative Considerations

The “Practice Option Matrix” in Figure 3-2 is an example of the quantitative segment of the Practice Option Report. The Practice Option Matrix provides a format for you and your accountant to prepare a long-term business plan, designed to assist you in choosing your desired form of practice. The Practice Option Matrix should be utilized not only to compare the options of practice form, but to compare the available options within one category, e.g., practices available for sale, associateships, etc.

The Practice Option Report should be in writing, typed and printed out so that it is complete. Unfortunately, the preparation of the Practice Option Report takes substantial effort, as does the preparation of any formalized business plan. Nevertheless, one method to obtain the practice you want is to formally plan for your results. After you are in practice, the Practice Option Report should be continued in the form of an ongoing strategic practice plan. This should provide you with a reference point to assess your continuing progress toward your goals and objectives. The

strategic practice plan also allows you to reexamine your decisions and goals in light of a changing economic, political, and social environment.

Purchase a Practice

The purchase of a practice should provide you with an immediate patient base, staff, and practice facility. You are immediately in practice after the acquisition. The economic cost, and associated benefit, of purchasing a practice would typically be weighed, prior to the purchase, against other options such as establishing a practice.

The primary consideration in acquiring a practice should be to ensure that you receive what you pay for. That is, you need to make sure you are acquiring the following: (a) certain tangible assets, consisting of dental equipment, office equipment, furniture, leasehold improvements, plumbing, electrical, and carpentry, etc., dental supplies, and office supplies; and (b) more importantly, the goodwill or going concern value of the practice and selling doctor(s), e.g., the patient and/or referral source base. Unless you are certain that the patient and/or referral source base will remain with the practice after its purchase, you should not proceed further.

Become an Associate and Later Be Elevated to Partnership

In acquiring a portion of a practice or in merging two or more practices into one, you are placing yourself into a partnership. Although there are advantages to partnership arrangements, such as expense sharing, mentorship, coverage of practice(s), sharing of ideas, etc., certain points should be considered to minimize the potential for dispute. Those points include decision-making control, the buy-out of other owner(s), the expense-sharing formula, the compensation allocation formula, the practice's ability to continue or replace the senior doctor's production upon retirement, the expense level in the event of the senior doctor's departure, restrictive covenants to protect the practice from competition by the departing senior doctor, and employment of spouses and other family members.

Become an Associate, Then Enter Into a Solo Group Arrangement

In a solo group arrangement, you associate, then purchase half or an undivided interest in half of the tangible assets of the practice. You will also purchase an undivided interest in the senior doctor's goodwill or those of the senior doctor's patient base whom you customarily treat as an associate. For example, the goodwill may equate 50% of your yearly production at the time you enter into the solo group. At that time, you would form a separate practice from Dr. Senior.

In this format, you and Dr. Senior would operate your respective practices pursuant to a written office-sharing agreement. This agreement would provide for the allocation of all expenses, distribution of non-referred new patients, maintenance of the premises, and certain other matters. Additionally, your practices would be subject to a buy-sell/dissolution agreement, which would provide for the departure of any owner, for any reason, from the shared facility.

The benefits of a solo group arrangement are to share expenses, maximize use of the practice facility, provide coverage for each practice in the facility, provide a purchaser in the event of death or disability of an owner, and retain independence so that you and Dr. Senior avoid the complexity of co-ownership. Most importantly, unlike in a co-ownership arrangement, there is no obligation to buy out Dr. Senior upon his or her retirement.

Associating

The benefits of associating with an existing practice are that you are employed and have the opportunity to learn and grow professionally; however, you do not own the practice. Hopefully, your association will lead to practice ownership, in whole or in part, by way of a solo group format, co-ownership arrangement, or complete acquisition.

To attain practice ownership through an association, you need to make the effort to locate and associate with a practice that you wish to own. While locating the right practice is not an easy task, the more effort you put into the process, the better your chances are of success.

View the associate period as an opportunity to prove yourself. Although there are generally no promises of practice ownership during the associate period, there can and should be a detailed discussion, prior to employment, of the potential for future ownership. This assumes that the associate period will be successful. The potential for ownership discussion should be memorialized through a non-binding letter, outlining the general parameters, terms, and conditions of both the associate arrangement and future ownership in the practice. By utilizing this format, the practice owner(s) and you should minimize the potential for misunderstandings relative to the associate period and future ownership. It should be noted that unless the practice owner(s) invites you to become an owner after proving yourself during the associate period, there would not be an opportunity for practice ownership.

Prior to commencing the associate period, you should be requested to review and sign an associate employment agreement. The employment agreement would include provisions relating to compensation and benefits, non-competition/non-disclosure, duties and responsibilities, vacations and other time off, and termination of employment.

We are seeing a drastic increase in corporate practices with multiple locations. Unless you are willing to accept the long-term proposition of working for someone else, make sure that your restrictive covenant is only for the location where you primarily work. If you plan to purchase, acquire a practice, or find a practice to later associate with, let the employer know that you will probably reduce your practice time, but may still desire to work for the corporate practice on a reduced schedule. Make sure that your notice period for termination is workable for you, e.g., 30 or 60 days. Be very cautious of employment contracts that make it difficult for you to terminate. Finally, ensure that your employment agreement provides that you will continue to be paid any commissions after you leave, with a written monthly accounting.

As an associate, you are an employee, not an independent contractor. The Internal Revenue Service (IRS) and individual states do not offer you or the employer a choice on worker classification. Where the practice bills the patients, pays the operating expenses, pays and schedules you, and where you are subject to a restrictive covenant, you are an employee and not a contractor.[4] Misclassification is costly for you and the employer.

Establish a Practice

As long as you are able to successfully establish a practice, you have no need to consider other options, such as purchasing a practice. However, you may choose to establish a practice and

[4] Prescott WP, Altieri MP, VanDenHaute KA, Tietz RI. Worker Classification Issues: Generally and in Professional Practices. *The Practical Tax Lawyer*. Winter 2017; 36(2): 17-28.

associate elsewhere, on a part-time basis, in order to support your family. In such a case, you would be analyzing two options. The most difficult phase of the analysis to establish a practice is the analysis of revenue for the first 2 to 3 years. Expenses are much easier than revenue to analyze.

Summary

Live your dreams and do not compromise in the long run.

Figure 3-1

PRACTICE OPTION REPORT
PRACTICE OBJECTIVES/QUALITATIVE SEGMENT

In narrative form, list your goals and career objectives in terms of the categories below:

A. Patient Demographics;

B. Method of Payment for Your Services;

C. Procedural Mix;

D. Practice Location;

E. Location of Residence;

F. Practice Form;

G. Mission Statement;

H. Continuing Education Statement;

I. Commitment to Learning the Business of Dentistry/Specialty Statement;

J. Practice Characteristics;

K. Community Involvement Statement;

L. Personal and Family Goals Statement;

M. Other Categories that You Deem Relevant; and

N. Available Opportunities.

Figure 3-2

PRACTICE OPTION REPORT PRACTICE OPTION MATRIX/QUANTITATIVE SEGMENT					
Annual Projected Budget	**Purchase a Practice and/or Associate and Later Purchase the Practice**	**Partnership**	**Solo Group Arrangement**	**Associate**	**Establish a Practice**
1. Revenues/Collections					
2. Total Operational Costs/List by Individual Expense Category					
3. Equipment Replacement/Remodeling Costs After Acquisition					
4. Owner/Associate Compensation					
5. Retirement Plan Contribution					
6. Provision for Income Taxes					
7. Owner/Associate Net Compensation					
8. Total Practice Debt Repayment					
9. Total Personal Debt Repayment					
10. Total Personal Expenses					
11. Cash Reserve					
12. Net First Year					
13. Net Through Second Year					
14. Net Through Any Specified Number of Years					

Chapter 4

THE ESSENTIALS OF THE PRACTICE VALUATION

The IRS has defined fair market value as the price at which property would change hands between a willing purchaser and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. In order to meet the IRS definition of fair market value, the purchaser and seller would be considered to be dealing at arm's length in a market based upon negotiation, supply, and demand.

Seller's Perspective

From the selling doctor's perspective, he or she expects to be paid the purchase price and be succeeded by a worthy incoming doctor(s) who will continue treatment of patients and retain referral sources in a specialty practice.

Incoming Dentist's or Specialist's Perspective

The incoming or purchasing dentist wants to have confidence that he or she will receive the patient and/or referral sources purchased.

Are Practice Values Declining?

Not yet, but soon! It is difficult to locate candidates who wish to practice in rural settings and in certain geographic areas of any state. However, quality practices with healthy profitability in desirable areas tend to retain value. Practices with uncontrolled overhead, staffing problems, inadequate scheduling policies, poor collections, and ineffective management systems in undesirable geographic areas are drastically declining in value. What's more, selling dentists in these practices have insufficient profitability to fund retirement plans. These are the practices in need of drastic operational changes and management training, or will be difficult to sellas they will not interest potential purchasers.

Verification Analysis

Irrespective of the valuation method used in appraising the practice, the purchaser's CPA should complete a "verification analysis." The analysis consists of four categories that the purchaser must be able to fulfill: earn a living, pay the operating expenses, pay the lender(s), and pay the purchase price within a measured time period, not to exceed 7 years. The verification analysis is a tool to determine whether the purchase price is realistic, regardless of the valuation method(s) used.

Although projected collections may be identical or similar to the historical collection rate of the selling dentist(s), the purchaser should calculate and determine the percentage of the seller's patient or referral base that will remain with the practice after its acquisition and any growth. For example, if it is anticipated that the patient base will decline by 10%, the resulting reduction in profit to the purchaser will be significant.

The compensation that a purchaser should earn while paying for a practice should be the same as what the dentist can earn as an associate, e.g., 25% to 30% of adjusted production, inclusive of hygiene examination fees, as a general dentist; the range is higher for a specialist. If the

purchaser cannot earn an acceptable living while paying for a practice over an anticipated repayment period, the purchase price is not acceptable.

To determine the annual operating and capital expenses of the practice that the purchaser will incur, add the selling owner's compensation in all forms, e.g., retirement plan contributions and fringe benefits to the owner. This sum should be subtracted from the annual revenue of the practice.

From the projected level of compensation needs, the purchaser must pay the lender(s) the purchase price. Remember, interest will be included on the repayment amount. Additionally, the tax ramifications must be considered relative to the repayment obligations.

Importance of Practice Profitability

Small percentage changes in owner compensation greatly affect a purchaser's ability to acquire a practice and pay for it within a measured time period. This is of particular importance in a partnership because the practice usually must expand or relocate to accommodate a second owner.

Capitalization Rates

It has been stated that the capitalization rate is equal to the time period for the repayment of the practice purchase price.[5] A reasonable time period to pay the lender(s) for a practice may be 5 or 7 years. This time period measures the degree of risk in the operation of the practice as an investment and provides for a capitalization rate of 20%. The lower the capitalization rate, the higher the value and vice-versa. An acquisition with a capitalization rate of 14% would be paid in approximately 7 years, and a practice acquisition with a capitalization rate of 25% would be fully paid in 4 years. When a practice is valued using a capitalization rate, such rate should include both the tangible assets and goodwill.

Because purchasing dentists have been such good borrowers, dental lenders and some banks are increasing repayment periods to 10 years and well beyond. The increased repayment period should be discussed with the purchaser's CPA and may be acceptable if the prepayment penalty is no longer than 1 year and it is recognized that additional interest is paid to the lender. However, the longer the repayment period, the greater the sum of the interest paid. Lending is a tool that should be managed by the purchaser's CPA with the help of a quality dental lender. Do not confuse the repayment period to the lender with the calculation of the purchase and selling price, which should be based on 5 or 7 years. Calculating the purchase price based on the lender's repayment period can significantly raise the purchase price with any increased repayment period greater than 5 or 7 years.

Capital Expenditures

To the extent that the purchaser anticipates, after the acquisition, equipment replacement costs, leasehold improvement costs, a relocation, or other capital expenditures of any nature, such expenditures reduce the available cash flow or owner's compensation. The extent that such

[5] Pratt SP. *Valuing Small Businesses and Professional Practices*. Homewood, IL: Dow Jones-Irwin; 1986:122.

expenditures will reduce the cash flow to the purchaser and the fair market value of the practice should be correspondingly reduced.

Accounts Receivable

The accounts receivable of the practice being sold are usually not purchased. Typically, the accounts receivable are collected by the purchaser's practice and paid to the seller, less an administrative fee, e.g., 5%. However, there are times when the accounts receivable may be sold at their collectible value in order to provide the purchaser with working capital. Contrast a complete purchase with a partnership in which the associate buys into an existing practice entity. In a partnership, the associate automatically acquires an interest in the accounts receivable, unless specifically excluded. Irrespective of whether the accounts receivable are acquired or not, their disposition needs to be considered. The value of accounts receivable after they are purged (meaning uncollectible accounts receivable are written off), become the "clean" accounts receivable, multiplied by slightly less than the historical collection rate.

Reduced Fees

Generally, the intangible value of the practice being valued should be reduced by the percentage that the reduced fee revenue to the total revenue. If reduced fees are assigned any intangible or goodwill value, carefully consider the subsequent impact on future profitability as a purchaser.

Co-ownership or Partnership Values

In a partnership, the practice value is calculated as if 100% of the practice is being acquired. After the value is determined, the percentage of the practice sold and acquired is a pro rata percentage. For example, if the fair market value of the practice is $1,200,000 and Dr. Junior acquires a 50% interest, the fair market value acquired equals $600,000. I do not like to include accounts receivable should not be included in a partnership because operating expenses continue to be paid from accounts receivable, and there is usually insufficient profit for the incoming doctor to pay fair value for the buy-in and distribute the accounts receivable to the senior doctor.

Valuation Data

The more complete and accurate the information to value the practice or to assess the accuracy of an existing valuation, the easier it will be for the purchaser to make an informed decision as to whether to purchase a particular practice. Assuming that a purchaser/candidate plans to purchase a particular practice, it is critical to obtain relevant information relating to the practice to confirm or determine the purchase price and terms. Figure 4-1 provides the basic information to be requested by the candidate. Prior to the release of the information, the candidate should sign a confidentiality letter stating that all information will remain private, only to be shared with the candidate's advisors and promptly returned to the seller should the candidate not proceed.

High and Low Revenue Practices

Very high and low revenue practices tend to be more difficult to sell than "average" size practices, although the average is moving upward. One reason this is occurring is because of school debt. Purchasers need to buy large practices to pay themselves, their school debt, operating expenses, and practice lender debt. For a high-revenue practice, it often takes more than two purchasers to produce the revenue that one or more high-revenue–producing dentists generate. Low-revenue practices cannot provide adequate cash flow to allow the purchaser to meet the purchaser's

financial obligations without a second job. For the seller(s), when two or more compatible doctors are needed to purchase a high-revenue practice, it becomes more difficult to find a combination of compatible talent in the pool of potential purchasers than it is to find one dentist. For this reason, a lack-of-marketability discount can sometimes be applied to high-revenue practices. And it looks as if corporate purchasers will become likely candidates to purchase high-revenue practices in a manner the profession has never before seen.

A high-revenue practice with high overhead costs is difficult to sell versus one with controlled overhead. High overhead reduces value. Low-revenue practices, on the other hand, sometimes close or are sold on a contingency basis based on the number of the seller's patients that become patients of the buyer. However, for contingency sales, be aware of state fee-splitting laws as well as the difficulty of merging a low-revenue practice with reduced fees into a fee-for-service practice.

The Importance of Accurate Values

What if the seller's practice is overvalued? A high value is sometimes set by the seller and sometimes by a practice broker. If the practice is sold in a complete sale, assuming that the seller is paid in cash, as is almost always the case, the seller has nothing to worry about economically. However, the purchaser can go broke. The purchaser's CPA should confirm that the valuation report is accurate. If it is not accurate, the CPA should adjust the value and if the revised value is not acceptable to the seller, the purchaser should look for another opportunity.

The problem for the seller occurs if the seller or broker sets an unrealistically high selling price and the practice does not sell. The longer a practice is on the market, the more difficult it becomes to sell. For example, a dentist with a practice valued at $350,000 several years ago would not sell the practice for $330,000, excluding the accounts receivable. The dentist subsequently could not sell the practice and had to work several more years. Afterward, the dentist sold the practice for a reduced value.

For purchasers, values and destination locations are based on supply and demand and not necessarily on appraised value. In these cases, the purchaser's CPA should calculate what the purchaser would earn after paying the lender, living expenses, and school debt given the repayment time period.

The rule is the longer the repayment period, the higher the selling or purchase price. Repayment periods are increasing because dentists and dental specialists are very good risks to specialty dental lenders.

If the value is overly high in a partnership, Dr. Junior will leave and Dr. Senior will be left with a large practice and no successor.

Summary

While I do not see prractice values declining at this time although there are certain geographic areas where values are uncertain. For sellers, save and operate the practice as profitably as possible, enjoy the work, and sell when ready. For purchasers, assess whether patients and/or referral sources will stay and authorize the CPA with dental experience to confirm, reject, or revise the seller's appraisal.

If the economics don't work in a partnership, everyone loses.

Figure 4-1

REQUESTED INFORMATION FOR VALUATION PURPOSES

A. Compatibility of Purchaser and Seller

1. Contrast the seller's practice mission and philosophy to yours;

2. Contrast the seller's personal values and work ethic to yours; and

3. Assess the seller's reason for departure from active practice.

B. Financial Information—the following information should be obtained and reviewed:

1. The practice's federal income tax returns for the lesser of the last 5 fiscal years or the number of years in practice;

2. Financial statements and balance sheets (assuming that they are prepared for the practice) for the lesser of the last 5 fiscal years or the number of years in practice and the current fiscal year to date; and

3. An aged trial balance of all practice accounts receivable and the historical practice collection records for the lesser of the last 5 fiscal years or the number of years in practice and the current fiscal year to date.

C. Practice Facility—the following information should be obtained and reviewed:

1. A floor plan of the practice facility;

2. An itemized list and the fair market value of all dental equipment being acquired including in the treatment room, darkroom, utility room, sterilization area, x-ray area, and laboratory;

3. An itemized list and the fair market value of all office equipment and furniture being acquired;

4. An itemized list and the fair market value of all tangible assets, personal and other items located in the practice facility that are not being acquired;

5. An itemized list and the fair market value of all tangible assets (dental equipment, office equipment, and furniture) leased by the practice or located in the practice facility to which the practice does not hold clear title; and

6. Maintenance records for all dental and office equipment from the date of purchase through the current date.

D. Lease and Real Estate—the following information should be obtained and reviewed:

1. A copy of the current lease, any renewal amendments, and any document evidencing recording of the lease; and

Figure 4-1

2. Copies of any deed, documents, and/or agreements relating to the practice owner's (or family members') ownership of the practice real estate.

E. Operations—the following information should be obtained and reviewed:

1. The number of active patients (patients treated in the past 24 consecutive months), as well as inactive patients (those patients not having any dental services rendered within the last 24 consecutive months);

2. A summary of the number of new patients in each consecutive month for the lesser of the last 5 fiscal years or the number of years in practice and the current fiscal year to date;

3. A summary of the current number of patients (and percentage of the practice) in recall, if applicable;

4. A current fee schedule and a summary of fee increases for the lesser of the last 5 fiscal years or the number of years in practice and the current fiscal year to date;

5. A specific list of those procedures performed by the practice and those referred to specialists, if applicable; and

6. Your own written evaluation of the area demand and potential for economic growth for a dentist/specialist in the geographic area where you intend to practice.

F. Employment Relations and Benefits—the following information should be obtained and reviewed:

1. Census of all employees of the practice, the hours worked, compensation levels, positions, responsibilities, and dates of hire (including former employees) for the lesser of the last 5 fiscal years or the number of years in practice and the current fiscal year to date; and

2. Copies of any employee handbooks, job descriptions, and/or other publications distributed to employees of the practice.

Chapter 5

CALCULATING PRACTICE VALUE IN 2018. IS IT CHANGING?

In 1979, I completed my first valuation of a general dental practice. Long before I was a lawyer, I was a dental equipment and supply company general manager. Since that time, I have prepared hundreds of valuation reports and, except for the following, do not see too many things changing: repayment periods are increasing, which tend to increase selling prices; areas of high demand and some specialties (due to high demand) are substantially increasing in value; and certain economically challenged geographic areas are facing declining values. I do not see the corporate practices entering the profession of dentistry having much of an effect on practice values except that corporate practices are now purchasing both general and specialty practices for traditional fair market value and are providing an additional source of purchasers.

The valuation methods discussed herein include summation of assets, capitalization of earnings, multiple of gross revenue, and similar practices. Excess earnings and discounted future earnings are described, but examples have not been included as I do not consider them appropriate for dentistry and its specialties.

The valuations contemplate a complete sale and purchase, although partial sale and acquisitions are based on a pro rata percentage of the practice interests being purchased. For example, if the dentist purchases a 50% interest, the purchase price is 50% of the practice fair market value or fair value.

Summation of Assets

Under summation of assets, the fair market value of the asset categories is calculated. The sum of those asset values is the fair market value of the practice. Those categories are tangible assets (consisting of dental equipment, office equipment, furniture, and technology), dental supplies, dental instruments, and goodwill (be it entity goodwill or personal).

Tangible Assets

The value of dental equipment may be determined by appraisal by your dental equipment and supply dealer. Dental equipment dealers charge only a modest amount for a dental equipment appraisal, but the appraisal typically will exclude office equipment, furniture, and technology. The fair market value of the tangible assets should be its value when it is in place and functioning, rather than the price that the dental equipment dealer could receive for the equipment sold as individual items, operational but not in place. For example, a 10-year-old “over the patient” unit is worth more in place and in an operational condition because a purchasing dentist can use it. This same dental unit is probably worthless stored in a dental equipment dealer’s warehouse area for resale, with its water lines corroding.

Another method of valuing dental equipment and other tangible assets is a straight-line depreciation over a period of years, e.g., 10 years, with a salvage value afterward, e.g., 20%.

An additional method of valuing tangible assets is through the balance sheet. The balance sheet should indicate the net book value of the tangible assets, less depreciation. Add back to the net book value a percentage of depreciation taken, e.g., 33%. However, this method should exclude accelerated depreciation.

There are some additional considerations. First, technology rapidly changes and established dentists may not keep pace. As a result, it may be necessary for the incoming dentist to update the facility and pay the associated costs, which could impact cash flow. Equipment that must be replaced immediately would not have any fair market value, regardless of salvage value. In fact, the value of the practice is reduced by the cost of the tangible asset replacement. Likewise, if certain tangible assets are not in place, such as a microscope in an endodontic practice, it will need to be purchased, probably immediately, and its cost would negatively affect cash flow and practice value.

The fair market value of dental equipment will be less for a purchaser/candidate if the seller is left-handed and the purchaser is right-handed, or vice versa. Not only will the equipment be of less value to the purchaser, but the cabinetry design, door entries, and assistant's system also will be incorrectly placed.

It is appropriate to review all repair invoices for the past 3 to 5 years and year-to-date for all tangible assets. Certain manufacturers may have ceased operations, and some items may have been discontinued with parts availability becoming a future problem. Additionally, certain equipment items may have a history of extremely high maintenance costs and never performed as intended. These items will not retain the same value as equipment items that do perform as intended. Every practice has at least one equipment item that is a continuing problem. Effective dialogue with the selling dentist should disclose the mechanical difficulties. Further, the service technician from your dental equipment and supply company with whom you plan to work should perform a maintenance check on the equipment before the practice is purchased.

Some dentists maintain equipment better than others and in accordance with manufacturer's standards. Others use equipment without regard for maintenance. The fair market value of the equipment should reflect the maintenance and use.

Treatment room layout can have an effect on equipment value. For example, if an intraoral x-ray machine does not reach all positions properly, the x-ray machine has less value than an x-ray machine properly placed.

If all treatment rooms in the practice have identical equipment and operating systems are standardized, then any procedure can be performed in any room, including the hygiene room(s). Additionally, the more functional the overall facility design, the more efficient the purchaser can be. As a result, the in-place value of the equipment in a well-designed facility will be greater than in one that is poorly designed.

Dental Supplies and Instruments

For dental supplies, the value is in having 3 to 4 months of supplies on hand. The calculation to determine supplies for the calendar or fiscal year that the value is based on is supplies, divided by 12 months, and multiplied by 3.

Do not take an actual inventory. Pricing an inventory is very time consuming. As a dental equipment supply salesman in the early 1970s, I priced inventories four times. Each one took about 40 hours to complete, and the supply value was 3 to 4 months on hand. Dental instruments, on the other hand, are valued at one-half of one percent of the gross revenue for the calendar year on which the valuation is based.

Goodwill

The value of goodwill assets can be thought of as the future cash flow attributable to a purchaser(s) operating the practice in place of the seller(s). This value is generally based on a number of subjective factors, all of which are rated differently by various appraisers. Figure 5-1 provides 30 factors, many of which will ultimately impact the two major factors of annual gross revenue and dentist compensation in all forms. The factors may all be weighted differently, depending on the characteristics of the practice. Although defining intangible asset value is subjective, some appraisers have attempted to develop rating systems of certain criteria affecting intangible asset value and will adjust upward or downward depending on the weight of the factor. For example, to a particular practice, one location may be more important than another.

Where intangible value is based on annual gross revenues, the multiplier has traditionally been between .2 and .5.[6] The Goodwill Registry's actual data found the statistical mean goodwill was greater than 47% of 1 year's collections.[7] Where intangible asset value is based on annual doctor compensation in all forms, the multiplier has traditionally been between 1.0 and 1.5.[8] Other authorities have used 50% to 80% of total earnings available to the dentist.[9] Of all rating criteria, I believe that the most important are annual revenue and dentist or specialist compensation in all forms. Where goodwill is based on owner compensation in all forms and the practice profitability is 40%, then the 1.0 times compensation converts to 40% of revenue. One and one-half times owner compensation equates to 60% of revenue, which is what I see as a current trend. The exception is destination locations and some specialty practices where the percentage is high.

Figure 5-2 is an example of a summation of practice assets. Assume that in this example, the selling owner's appraisal is 65% of revenue as the purchase price and that the fair value of tangible assets is $130,000. If yearly revenue is $1,000,000 and tangible assets are $130,000, the goodwill is $500,000 or 50% of revenue. The purchase price in this example is 65% of revenue, or $650,000.

Verification Analysis

Figure 5-3, Verification Analysis, determines at what price a practice can afford to purchase itself.[10] Note that a 5% interest rate was used in these figures. If a purchaser's only income source is the practice, the purchaser should pay no more than the cash flow that the practice can support within a measured period of time. Additionally, the purchaser requires a yearly compensation level to live on while paying for the practice, but typically not at the compensation level of the prior owner(s). In determining the compensation level for a purchaser while paying for a practice, the

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[6] Baumann PA, Berning R. *The ADA Practical Guide to Valuing a Practice: A Manual for Dentists.* American Dental Association; 2013.

[7] *The 2017 Goodwill Registry*. The Health Care Group, Plymouth Meeting, PA; 2017.

[8] Domer L, Berning R. *Valuing a Practice, A Guide for Dentists*. Practice Management Series, American Dental Association; 2006:47.

[9] Pratt SP, Reilly RF, Schweihs RP. *Valuing Small Businesses and Professional Practices*. 3rd ed. New York, NY: McGraw-Hill; 1998:606.

[10] Pratt S. *Valuing Small Businesses and Professional Practices*. Homewood, IL: Dow Jones-Irwin; 1986:310.

purchaser should review the compensation that he or she could or does earn as an associate, recognizing that the purchased practice will eventually be paid for. The question is then how long should the repayment period be?

The verification analysis can be thought of as a "check" against any valuation method to determine the affordability over a predetermined repayment period. The verification analysis in Figure 5-3 considered working capital needs, renovation/equipment replacement requirements, and the practice loan. Assuming no decrease in yearly revenue, the purchaser earns 27.11% of revenue as compensation in all forms. Hygiene profit is included in the amount. In the example provided, the purchaser has 15 considerations to analyze. In particular, item 9 of the considerations questions the economic stability of the practice if revenue, patients, and/or patient referral sources decrease. Note that the second column of Figure 5-3 shows the effect of a 10% decrease in annual revenue. If revenue decreases by 10%, the purchaser earns 20.78% of revenue as compensation in all forms. The only operating expense decreases in this example are dental supplies and laboratory costs at 6% and 10%, respectively.

If there are no remodeling and equipment replacement costs or working capital needs, the yearly owner compensation in all forms will be higher. However, if no operating capital is borrowed, then the accounts receivable will be purchased to maintain practice operations.

The summation of assets method of valuation adds together all tangible asset categories of the practice being sold and acquired, as well as the intangible assets being sold to the purchaser by the practice or departing practice owner.

After the asset values are totaled, the verification analysis should be completed by the purchaser's CPA to determine what the likely purchaser compensation will be, while paying the operating expenses and the purchase price to the lender(s), all in a measured time period.

Capitalization of Earnings

The term "capitalization rate" can be thought of as the percentage by which a constant income stream is divided in order to obtain the value of the business on the basis of an assumed rate of return.[11] The income stream represents the annual sum available from gross revenues after the payment of operating expenses for the purchaser, the purchase price to the lender(s), and an "agreed" compensation amount to the purchaser. Provided that the stream of income being capitalized is constant, the multiple is the reciprocal of the capitalization rate. This sum would also be exclusive of interest or the time value of money.

Capitalization rates are determined by the market, and when expressed as a percentage return on an expected stream of income, the capitalization rate represents the rate of return available in the market on investments expected to produce similar streams of income.[12] Capitalization rates are based on the nature of the business, the risk involved, and stability or irregularity of earnings.[13]

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[11] Pratt S. *Valuing Small Businesses and Professional Practices*. Homewood, IL: Dow Jones-Irwin; 1986:122-123.

[12] Pratt SP, Reilly RF, Schweihs RP. *Valuing Small Businesses and Professional Practices*. 3rd ed. New York, NY: McGraw-Hill; 1998:209.

[13] Revenue Ruling 59-60, Section 6.

As a starting point for determining an appropriate capitalization rate for dental or dental specialty practices, it is appropriate to consider determining the rate of return for U.S. Treasury bills and long-term U.S. Government bonds, a relatively safe investment, and then adding back points to compensate for the risk and illiquidity of the investment in the practice.[14] The capitalization rate would be adjusted upward or downward according to various factors that impact practice value, e.g., the factors in Figure 5-1. A low capitalization rate yields a high practice value and vice versa. For example, a 20% capitalization rate would be a multiple of 5. This represents a much lower purchase price than a 14.28% capitalization rate or a 7-year repayment period. A 25% capitalization rate would be a multiple of 4 or a 4-year repayment period. Note that the capitalization of the earnings is typically exclusive of interest. Therefore, slight increases or decreases in the capitalization rate or repayment period create substantial variations in practice value; practice profitability directly determines the amount available to be capitalized, and new owner compensation and benefit levels also directly determine the amount available to capitalize over a measured time period.

Figure 5-4 provides for purchaser compensation of 25% of $1,000,000 in annual revenue or $250,000. Again, this includes hygiene revenue. It should be recognized that it may take two purchasers to produce at this level, which has the effect of decreasing the candidate pool. In the capitalization of earnings method of valuation, tangible assets and goodwill are included in the sum available to be capitalized. In line 8, there is $131,344 available, exclusive of interest, to pay for the practice over 5 or 7 years. Decrease revenues by 10% in line 8 with the same 25% of purchaser compensation, and the purchase price is significantly reduced.

What was not considered regarding the determination of capitalization rates in Revenue Ruling 59-60, Section 6, was the ability of a business owner, the dentist, to successfully establish his or her own business or practice. Different dentists and specialists have varying abilities and personalities that assist or hinder them from developing a patient or referral base in a start-up mode. Therefore, the opportunity to purchase a practice may be more valuable for one dentist without the ability to develop a patient or referral base, as opposed to another, irrespective of technical and clinical skills.

For example, a general dentist developed a practice on a second floor in a location without an elevator. Initially, she had to work at other practices. The dentist operated out of one treatment room, and overhead was kept at a minimum. The office was nicely decorated with many photographs of friends and patients, along with other personal items. This doctor had always enjoyed the profession of dentistry and radiated the enjoyment of the profession to everyone with whom she came into contact. Eventually, the dentist's practice became well established, and several years later, the dentist moved into her own building to accommodate growth. This particular dentist's attitude and love for dentistry attracted patients and helped her create a successful practice. Because the dentist had the desire and learned the skills to establish a practice, it would have been inadvisable for her to purchase a practice.

In another example, a dentist walked away from a very good opportunity to become a partner. Instead, the dentist established a practice and struggled to attract a sufficient number of patients to become profitable.

[14] Pratt SP, Reilly RF, Schweihs RP. *Valuing Small Businesses and Professional Practices*. 3rd ed. New York, NY: McGraw-Hill; 1998:209-210.

I find Figure 5-5, Capitalization of Earnings, interesting. This example shows that small variances in profitability have a significant impact on the practice's value. In this figure, the practice has $1,000,000 in yearly collections, owner compensation of 27.5% of collections and profit of 38%, 40%, and 42%. If we utilize the 20% capitalization rate on the available profit to pay for the practice, the results differ significantly.

Multiple of Gross Revenue

Although the multiple of gross revenue method of valuing a practice is relatively simple, this method should not be used alone, as it does not account for the particular characteristics, positive or negative, of the practice being valued. The multiple of gross revenue is often used in geographic areas of high demand and a low number of practices for sale in certain specialties where supply does not match demand.[15]

Figure 5-6 shows an example of the multiple of gross revenue approach. The dental practices in this example averaged a multiple of gross revenue of 64%.

Figure 5-7 provides a recap of practice values. Although not necessary, it is common to value a particular practice using more than one method. Often, all methods used are averaged to arrive at the determination of fair market value for the practice being appraised. However, if the verification analysis does not support the assessed fair market value, it does not matter what method is used if the economics of the sale and acquisition do not provide for a win/win transaction between the parties.

Methods That Don't Work Well for Dentistry

Excess Earnings

The excess earnings method or "formula" approach to valuing a practice is premised on the capitalization of earnings to determine the value of intangible assets and is described in Revenue Ruling 68-609 (Figure 5-8). The steps in this method are as follows:[16]

1. The fair market value of the "hard" or tangible assets should be determined;

2. The annual practice earnings, averaged over the past 5 years, should be determined after deducting owner compensation;

3. An appropriate rate of return should be ascertained, 8% to10%,[17] on the value of the intangible assets as a return on investment;

4. The return on tangible assets should be subtracted from the annual practice earnings;

[15] Baumann PA, Berning R. *The ADA Practical Guide to Valuing a Practice: A Manual for Dentists.* American Dental Association; 2013.

[16] Revenue Ruling, 68-609.

[17] Ibid.

5. The annual practice earnings, less the return on tangible assets, should be capitalized—the resultant amount is the goodwill or intangible asset value of the practice; and

6. The tangible and intangible assets are added, and the sum is the value of the practice.

Although the formula approach has been considered valid case law, this Ruling states that the formula approach should not be used if there is better evidence available to determine the intangible asset value. In the second edition of this book, I included an example of this method. However, I have not included such in the third edition because I do not believe this to be one of the better methods of valuing a dental or dental specialty practice. It is worth mentioning, however, because some appraisers do use this method of appraisal.

Discounted Future Earnings

Some appraisers use the discounted future earnings method to value practices. This method is based on the benefits and earnings that will be produced by the practice in future years, discounted back to a present value at some discount rate.[18] This method was not historically used in the valuation of dental and dental specialty practices, but it is now becoming more popular, regardless of the fact that future profits would be based on the purchaser's efforts as the new owner of the practice, as opposed to past efforts of the seller. However, it can be difficult to reliably predict future earnings in a changing market. Alternatively, capitalization rates reflect the historical profitability or earnings of the practice.[19]

Requested Information

The more complete and accurate the information for which to value the practice, the more effective the practice valuation. The items needed are as follows:

1. The practice's federal income tax returns for the past 5 years;

2. Financial statements (if they are provided for the particular practice) for the past 5 years and the year to date;

3. A copy of the current lease and any renewal amendments;

4. A floor plan of the practice facility;

5. A listing of all dental equipment by room, plus darkroom, utility room, sterilization area, x-ray area, and laboratory;

6. A listing of all office equipment and technology;

[18] Pratt SP, Reilly RF, Schweihs RP. *Valuing Small Businesses and Professional Practices*. 3rd ed. New York, NY: McGraw-Hill; 1998:236.

[19] Pratt SP, Reilly RF, Schweihs RP. *Valuing Small Businesses and Professional Practices*. 3rd ed. New York, NY: McGraw-Hill; 1998:236.

7. Maintenance records for all dental and office equipment for the last 5 calendar years and the year to date;

8. An aged trial balance of all accounts receivable;

9. An accurate description of treatment procedures performed and those referred out.

10. A current fee schedule and a summary of fee increases over the last 5 years, as well as the corresponding amounts;

11. The number of active patients (patients treated in the last 18 months), as well as inactive patients;

12. A summary of the number of new patients per month over the last 5 years and the year to date; and

13. A list of all employees, hours worked, compensation levels, and dates of hire, including former employees, over the last 5 years and the year to date.

Under normal circumstances, it is difficult to obtain all information requested in valuing a particular practice. If some requested information is unavailable, the appraiser must make certain assumptions based on the information that is available, while noting the information on which the appraisal is based. However, certain information is crucial, such as federal tax returns and accurate year-to-date financial information.

Note that photographs and videos of the practice facility are helpful because they force the seller to understand that someone else will be looking at the layout and appearance of the premises. A visit to the practice is clearly the best approach, but it needs to be weighed against the additional cost of the appraisal, which should be budgeted in advance.

Important and Historical Ruling

Figure 5-8 includes a summary of four rulings that I believe helped to shape the valuation methods used in valuing small businesses and professional practices.

Summary

Of all valuation methods described in this chapter, the one common factor is that the determination of fair market value will be subjective, but market driven.

Figure 5-1

PRACTICE PROFILE FACTORS FOR SELECTION OF CAPITALIZATION AND GOODWILL RATES

1. Annual owner compensation in all forms
2. Annual gross revenues of the practice
3. Operating expenses as a percentage of gross revenues
4. Ability of the seller(s) to transfer the patients and/or referral sources of the practice
5. Number of active patients/referral sources in the practice
6. Number of new patients per month and degree of patient turnover/The number of referral sources in the practice
7. Stability of the practice and surrounding community
8. Competition
9. Fee structure
10. Practice location
11. Demographic characteristics of patients, location, age, and income
12. Likelihood that staff, including any associate doctor(s), will remain with the practice after it is sold
13. Availability of lender or seller financing
14. Facility design and square footage
15. Number of treatment rooms, age, and condition of dental equipment (right or left handed)
16. Overall appearance, aesthetics, and condition of practice facility — Do I need to relocate?
17. Reputation of the practice
18. The number of hours and days worked per year
19. The percentage of patients covered by insurance/managed care/Medicaid/other
20. Assignability and term of lease/availability of practice facility, land, and building for purchase
21. Ability to expand the practice facility
22. Patient and/or referral source demographics

Figure 5-1

23. Percentage of collections to gross revenues and age

24. Willingness of seller to assist the purchaser in practice transition

25. Parking and public transportation availability

26. Effectiveness of recall system

27. Quality of patient records and clinical work performed

28. Quality and experience of staff and degree of turnover

29. Effectiveness of management systems

30. Entity form/completeness of accounting and legal records, as well as any owner agreements, e.g., buy-sell agreement

Figure 5-2

SUMMATION OF PRACTICE ASSETS

I.	**Estimated Fair Market Value (FMV) of Tangible Assets of the Practice**			
	A.	FMV of Dental Equipment, Office Equipment, Furniture, and Technology		
		1. Balance sheet approach — Book value, plus 1/3 accumulated depreciation		
		2. Tangible asset appraisal by dental equipment supply company, but must include office equipment, technology, and furniture		
		3. 15 years straight-line depreciation		
		4. 12 years straight-line depreciation with de minimis salvage value		
		5. Estimated FMV of dental equipment, office equipment, furniture, and technology	$	130,000
	B.	Leasehold Improvements — Not Owned by Seller		
	C.	Dental Supplies		
		1. Dental supplies @ 6% of $1,000,000	$	60,000
		2. Divided by 12 months		÷ 12
		3. Monthly cost of dental supplies	$	5,000
		4. Three-month multiple		x 3
		5. Estimated FMV of dental supplies	$	15,000
	D.	Dental Instruments @ 1/2% of $1,000,000	$	5,000
		1. Estimated FMV of dental instruments	$	5,000
	E.	Recap of Tangible Asset Categories		
		1. Dental equipment, office equipment, furniture, and technology	$	130,000
		2. Leasehold improvements		N/A
		3. Dental supplies	$	15,000
		4. Dental instruments	$	5,000
		5. Estimated FMV of tangible assets of the practice	$	150,000
II.	**Agreed Intangible Asset Value of the Practice and/or Personal Goodwill of Selling Owner at 50% of Practice Revenue of $1,000,000**		**$**	**500,000**
III.	**Estimated FMV of the Practice and/or Personal Goodwill of Selling Owner**		**$**	**650,000**

Figure 5-3

VERIFICATION ANALYSIS

		No Revenue Decrease	Revenue Decrease of 10%
1.	Practice Revenue:	$1,000,000	$900,000
2.	Proposed Selling Price of the Practice at 65% of Revenue: (Practice Assets, $150,000; Goodwill, $500,000 or 50% of One Year's Gross Revenue):	$650,000	$650,000
3.	Less Payment of Debt Service for Practice (Yearly Payment of Selling Price Over 7 Years @ 5%):	<$110,244>	<$110,244>
4.	Less Working Capital — Assumes Account Receivables Not Purchased (Yearly Payment of $60,000, Payable Over 7 Years @ 5%):	<$10,176>	<$10,176>
5.	Less Remodeling and Equipment Replacement Costs (Yearly Payment of $50,000, Payable Over 7 Years @ 5%):	<$8,480>	<$8,480>
6.	Practice Operating Expenses @ 60% of Revenue/10% Lab; 6% Supplies:	$600,000	$584,000
7.	Adjusted Yearly Owner Compensation @ 40% of Revenue/Reduced Revenues:	$400,000	$316,000
	(Owner's net profit from federal income tax return, plus the following: (a) automobile expense; (b) existing equipment lease paid off by the selling doctor; (c) retirement plan contribution for the doctor(s); (d) continuing education; (e) travel expense; (f) entertainment expense, less (1) rental increase after acquisition; (2) wages, part-time employee)		
8.	Less Total of Items 3, 4, and 5:	<$128,900>	<$128,900>
9.	Yearly Available Compensation for Purchaser:	$271,100	$187,100
10.	Ratio of Compensation for Purchaser to Average Revenue where Initial Remodeling, Equipment Costs, and Working Capital are Considered ($271,100/$187,100 ÷ $1,000,000/$900,000 = 27.11%/20.78%) **(Includes Hygiene)**:	27.11%	20.78%

Figure 5-3

11.	Ratio of Compensation for Purchaser to Average Revenue where Initial Remodeling, Equipment, and Working Capital Are Not Considered ($400,000/$316,000, Less: Yearly Payment of the Selling Price of $110,244 = $287,750/$205,756) ($289,756/$205,756 ÷ $1,000,000/$900,000 = 28.98%/22.86%)	28.98%	22.86%

Considerations

1. Can you maintain yearly revenues of $1,000,000/$900,000?
2. To what extent will the seller work post-closing and how will this affect your cash flow?
3. Is this an associate buy-in and how is this different from a complete purchase and sale?
4. What is the effect of an increased repayment term for 5 or 7 to 10 or 15 years?
5. Is the anticipated compensation package fair, while paying for the practice or practice interest in light of what you can earn as an associate non-owner?
6. Should you acquire another practice in light of your available choices?
7. Should you start your own practice in light of your available choices and given area demographics?
8. Revenue increases — are you selling or acquiring potential?
9. What if revenues, patients, and/or referral sources decrease? How does this analysis change?
10. What is the tax and business structure of this complete sale or associate buy-in and what are the implications to you?
11. Is this a fee-for-service practice? To what extent does the practice participate in reduced fee plans?
12. What procedures are performed in this practice and what procedures are referred to specialists? — What unique services does this practice provide that you do not do, e.g., orthodontics, TMJ, cosmetic services, endodontics, etc.?
13. How much of the goodwill of the practice is corporate and how much is personal to the selling owner?
14. The $500,000 question: How much of the goodwill is transferable?
15. Is the practice located in a “destination” area?

Figure 5-4

EARNINGS APPROACH — ANOTHER WAY OF LOOKING AT THIS!

		No Revenue Decrease		Revenue Decrease of 10%	
1.	Revenue:	$1,000,000		$900,000	
2.	Operating Expenses:	<$ 600,000>		<$584,000>	
3.	Less Working Capital Needs (Yearly Payment of $60,000, Payable Over 7 Years @ 5%:.....	<$ 10,176>		<$10,176>	
4.	Less Remodeling and Equipment Replacement Costs (Yearly Payment of $50,000, Payable Over 7 Years at 5%)	<$ 8,480>		<$8,480>	
5.	Subtotal: Operating Expenses, Remodeling and Equipment Replacement Costs, and Working Capital Needs:	<$ 618,656>		<$ 602,656>	
6.	Yearly Available Owner Compensation in All Forms:	$ 381,344		$ 297,344	
7.	Less Compensation Requirements for Purchaser @ 25% of Practice Revenue:*.....	<$ 250,000>		<$ 225,000>	
8.	Yearly Available Sum to Pay Purchaser Price Exclusive of Interest:.....	$ 131,344		$ 72,344	
9.	Above Sum, Multiplied by 5 Years, Exclusive of Interest**:.....	$ 656,720		$ 361,720	
10.	Above Sum, Multiplied by 7 Years Exclusive of Interest:.....	$ 919,408		$ 506,408	
11.	Purchase Price as a Percentage of Gross Revenue — 5 Years:	$ 656,720 / $1,000,000	=65.67 %	$ 361,720 / $ 900,000	=40.19%
12.	Purchase Price as a Percentage of Gross Revenue — 7 Years:	$ 919,408 / $1,000,000	=91.94 %	$ 506,408 / $ 900,000	=56.27%

* Should compensation be a percentage of revenues or the associate's current yearly compensation, e.g., $120,000? Answer — A percentage, because it may require an additional dentist or specialist to produce at this level. Note that the 25% includes hygiene revenue.

** Should interest be included or excluded as the time value of money? If interest is excluded, to what extent will the repayment period be increased? Answer — Interest is excluded, as it can change, and sometimes change very quickly.

Figure 5-5

CAPITALIZATION OF EARNINGS

Most Recent Year Collections	$1,000,000	$1,000,000	$1,000,000
Owner Profit Percentage	x 38%	x 40%	x 42%
Available Profit	$380,000	$400,000	$420,000
New Owner Compensation at 27.5%	<$270,500>	<$270,500>	<$270,500>
Available Profit to Capitalize at 20% Rate	$109,500	$129,500	$149,500
20% Capitalization Rate	÷ .2	÷ .2	÷ .2
Estimated FMV of the Practice	$547,500	$647,500	$747,500

Small Increases in Profitability Have Significant Effects on Practice Value

Figure 5-6

MULTIPLE OF GROSS REVENUE

1.	Gross Revenue	$ 1,000,000
2.	Gross Revenue Multiplier	64%
3.	Practice Value	$ 640,000

Figure 5-7

RECAP OF PRACTICE VALUES

1.	Summation of Assets	$ 650,000
2.	Capitalization of Earnings	$ 643,810
3.	Multiple Gross Revenue	$ 640,000
4.	Subtotal	$ 1,933,810
5.	Averaged	÷ 3
6.	Estimated FMV of the Practice	$ 644,603

Figure 5-8

FOUR IMPORTANT AND HISTORICAL RULINGS

1. Revenue Ruling 59-60.

Revenue Ruling 59-60 set forth the relevant criteria for determining fair market value of a closely held business, a business with a relatively small number of owners, or a practice for estate and gift tax purposes. The factors that should be considered in the determination of fair market value are as follows:

(a) The nature and history of the business from its inception;

(b) The economic outlook in general and the condition and outlook of the specific industry in general;

(c) The book value of the stock and the financial condition of the business;

(d) The earnings capacity of the business;

(e) The dividend paying capacity;

(f) Whether or not the business has goodwill or intangible asset value;

(g) Sales of the stock and the size of the block to be valued; and

(h) The market price of stocks of corporations engaged in the same or similar businesses.

Revenue Ruling 59-60 also went on to indicate that fair market value depends on the circumstances of each case and is not an exact science. It changes with general economic conditions, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. In many instances, the best measure of fair market value may be the price of similar practices.

Additionally, profit and loss statements should be obtained for 5 or more years. Earnings are one of the most important criteria of value in cases in which products and services are sold to the public, whereas the value of the assets is the most important criteria in valuing closely held investment or real estate holding companies.

As to capitalization rates, there is no ready or simple solution and wide variations will be found for companies within the same industry. Additionally, the capitalization rate will fluctuate from year to year depending on general economic conditions. The factors that should be considered in determining the capitalization rate include the nature of the business, the risk involved, and the stability or irregularity of the earnings.

Because valuations cannot be made on the basis of a prescribed formula, there are no means to weigh the various applicable factors of a particular case in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors or methods of valuations, such as book value, capitalized earnings, and capitalized dividends, and basing the valuation on such a result. Such a process excludes active consideration of other pertinent

Figure 5-8

factors, and the end result cannot be supported by a realistic application of the significant facts, except by mere chance.

As to the fair market value of buy-sell agreements, the stated purchase price of the stock is a factor to be considered with other relevant factors, including fair market value for estate tax purposes. It is always necessary to consider the relationship between the parties, the number of shares held, and other material facts to determine whether the buy-sell agreement represents a bona fide business arrangement or is a device to pass a decedent's shares to the natural objects of his or her bounty for less than adequate and full consideration for money.

2. Revenue Ruling 65-192.

Revenue Ruling 65-192 expanded Revenue Ruling 59-60 and stated that the methods and factors outlined in Revenue Ruling 59-60 for use in estate and gift tax purposes applied equally to valuations for income and other tax purposes and were also useful in determining the fair market value for business interests for any type and the intangible assets, for all tax purposes. Revenue Ruling 65-192 also discussed a capitalization rate of 20% on excess earnings.

3. Revenue Ruling 65-193.

Revenue Ruling 65-193 modified Revenue Ruling 59-60 by stating that the instances in which it is not possible to make a separate appraisal of the tangible and intangible assets are rare. Revenue Ruling 65-193 suggested that tangible and intangible assets be valued separately.

4. Revenue Ruling 68-609.

Revenue Ruling 68-609 considered the formula or excess earnings approach for the determination of fair market value. It further suggested the use of a capitalization rate of 15% to 20% on intangible assets and an 8% to 10% rate of return on tangible assets.

Chapter 6

NEGOTIATING THE WIN-WIN SALE AND PURCHASE

A sale and acquisition is a complete sale by a third-party dentist or associate who has the obligation to purchase the practice at a specified date or earlier upon the selling dentist's or specialist's death or disability.

In the process for the sale and purchase, the advisors to both parties should agree on the value of the practice, consider the tax effects and possible alternatives, negotiate the "one best method" to complete the transaction, and confirm the outcome after the sale and purchase to both the seller and purchaser.

Asset Sale

In an asset sale, the purchaser acquires all or part of the seller's assets and does not want to assume any of the seller's liabilities unless specifically agreed upon, e.g., amounts owed on dental equipment or expansion loans. For the purchaser, an asset sale is more preferable than the purchase of stock, which is paid in after-tax dollars. An asset purchase allows a purchaser to allocate the purchase price to the assets of the practice in accordance with Internal Revenue Code (IRC) Section 1060. In other words, the purchaser can amortize or depreciate all purchased assets, including goodwill.

Reporting Requirements

IRC Reg. 1060-1T(h) requires the seller and purchaser in an asset acquisition to each report on IRS Form 8594 specific information about the allocation of the purchase price among the assets transferred. Although the allocation of the purchase price on Form 8594 will be binding on both the purchaser and seller pursuant to a written agreement, the IRS retains the ability to challenge the taxpayer's determination of the fair market value of any asset. If the purchaser and seller have not reached a written agreement regarding the allocation of the purchased assets, they would file Form 8594 individually. The allocation of the purchase price in a dental or dental specialty practice transfer becomes more significant at any time the difference between capital gains and ordinary income treatment widens.

Contingent Liabilities

An asset acquisition permits the purchaser to acquire assets of the practice only and not acquire unknown or contingent liabilities. This is not the case in a stock purchase, although this problem can generally be avoided or minimized if the seller indemnifies or holds harmless the purchaser from any potential liabilities of the practice arising prior to the closing date and the purchaser does the same for the seller after the closing date.

Like-Kind Exchanges

In an asset acquisition in which the dentist is planning to sell his or her practice and purchase another shortly thereafter, applying IRC Section 1031, like-kind exchange treatment, may be possible. If certain tests are met, such treatment would defer any gain to the purchaser on tangible like-kind property, such as dental equipment. It should be noted that the regulations under IRC Section 1031 are relatively complex and require that the new assets, i.e., dental equipment, be

identified within 45 days of the closing of the first practice sale. The closing of the subsequent practice purchase must take place prior to 180 days after the first practice sale. In short, property covered by IRC Section 1031 is deferred from IRC Section 1060 treatment. While IRC Section 1031 usually pertains to real estate, it can also be applicable to dental equipment. Under regulations issued in year 2000, reverse exchanges are now permitted where the second property can be acquired prior to the sale of the first property. This change provides additional planning opportunities not previously present in like-kind exchanges.

Goodwill

IRC Section 197 was issued pursuant to the Revenue Reconciliation Act of 1993 and provides for intangible assets, including goodwill, going concern value, and covenants not to compete, to be depreciated by the purchaser over a 15-year period. Prior to August 10, 1993, goodwill was not depreciable. At that time, covenants not to compete were amortized by the purchaser over the length of the covenant period, typically 3 to 5 years. Currently, covenant compensation must also be depreciated over 15 years and is considered ordinary income to the selling dentist. If consulting fees or other compensation is paid to the seller for services rendered for the purchase, such amounts are not considered covenant compensation. The compensation is deductible to the purchaser and is considered ordinary income to the seller. Caution: the consulting fees are only deductible where consulting services are provided.

Personal Goodwill

In the sale and purchase of assets of a dental or dental specialty practice, goodwill represents 75% to 90% of the selling and purchase price and 25% to 10% of the tangible assets. Because goodwill is the largest part of the consideration or price, the character of its taxation is very important.

For those dentists or specialists who practice through C-corporations, the sale of the corporation's assets is double taxed, 35% at the corporate level and another 20% at the individual level.[20] The double tax problem is applicable only to C-corporations and S-corporations that were C-corporations within the last 10 years (collectively a C-corporation).[21]

Since 1998, advisors have attempted to minimize or eliminate the double tax by taking the position that one's goodwill is personal and not a corporate asset by relying on two favorable tax court cases, *Martin Ice Cream* and *Norwalk*.[22] Based on these cases, goodwill that is characterized as personal is taxed once at favorable capital gains rates, currently 20%. To the extent that the dentist's or specialist's goodwill is personal, the double tax is avoided.

As a result of *Martin Ice Cream* and *Norwalk*, there has been a "trend" in thinking that a dentist can elect to sell personal goodwill rather than corporate goodwill and avoid a double tax.[23] Either

[20] Tax Reform Act of 1986, Pub. L. 99-514, 1986-3 C.B. (vol. 1) 1.

[21] Internal Revenue Code (IRC) Section 1374.

[22] *Martin Ice Cream Co. v. Commissioner*, 110 T.C. 189, 208 1998 WL 115614 (1998) (Martin Ice Cream); *Norwalk v. Commissioner*, T.C. Memo 1998-279, 76 TCM 208 (1998) (Norwalk).

[23] The Internal Revenue Service (the IRS) is well aware of what it considers tax avoidance and is looking at practice and business sales involving personal goodwill; American Bar Association, Section of Taxation

way, the purchaser is unaffected and will amortize or deduct goodwill, personal or corporate, over 15 years. However, the purchaser's CPA should consider a downward adjustment based on a tax-neutral practice valuation due to the lengthy amortization period over 15 years. Depreciation recapture is an additional planning point to be considered by the purchaser's CPA because future practice sales proceeds are taxed at ordinary income rates rather than as favorable capital gains.[24] The depreciation recapture may result in yet another downward price adjustment to the tax-neutral purchase price.

The selling dentist cannot have a restrictive covenant with the existing corporation and sell personal goodwill. Under both the *Martin Ice Cream* and *Norwalk* cases, had the shareholders been subject to restrictive covenants with their respective C-corporations, there would not have been any personal goodwill. In one case involving a dentist,[25] the dentist had a restrictive covenant with his corporation and lost both the case and appeal.[26,27,28]

In order to allocate goodwill as personal, the selling dentist should have an employment agreement with the purchaser.[29]

The *Howard* appeal noted that the post-sale, services agreement with the purchaser was through the dentist's corporation and should have been through the dentist personally in order for personal goodwill to exist.

The selling dentist should authorize an appraisal of any personal goodwill. In *Kennedy,*[30] the Court noted that the shareholder did not have an appraisal of the personal goodwill versus the corporate goodwill. The court further noted that the allocation to personal goodwill was an afterthought by Mr. Kennedy's accountant and was done to avoid taxes. Had Mr. Kennedy not shown evidence that he relied on the advice of his accountant, he would have incurred a 20% accuracy related penalty.[31] An appraisal of personal versus corporate goodwill should be distinguished from an appraisal of the seller's dental practice that does not consider whether the goodwill is personal or corporate.

Meeting, Closely Held Businesses Committee, May, 2009, Panel — "Update on Personal Goodwill", Washington, D.C.

[24] IRS Section 1245.

[25] *Howard v. U.S.*, 2010 WL 3061626 (E.D. Wash.), July 30, 2010 (*Howard*); United States Court of Appeals for the Ninth Circuit, No. 10-35768, D.C. 2:08-cv-00365-RMP (the *Howard Appeal*).

[26] Prescott WP, Rang PD. Perils for Practice Transition: Double Taxation of Goodwill. *Dent Econ*, 2010; 100(11): 90,92,94.

[27] Prescott WP, Rang PD. Current Developments and Sale of Personal Goodwill, *The Practical Tax Lawyer*, 2011; 25(3): 47-50.

[28] Prescott WP, Rang PD. Taxing Decisions: More Current Developments in the Sale of Personal Goodwill, *The Practical Tax Lawyer*, 2012; 26(3): 5-7.

[29] *Solomon v. Commissioner*, T.C. Memo. 2008-102, (*Solomon*).

[30] *Kennedy v. Commissioner*, T.C. Memo. 2010-206, (*Kennedy*).

[31] IRC Section 6662.

The use of personal goodwill is workable in certain situations, but is rather limited. Most of all, an appraisal of any personal goodwill versus corporate goodwill is vital!

Form 8594. Form 8594 is required under the Tax Regulations[32] to report the allocation of the purchase price in an asset sale in accordance with defined categories. Depending on the fair market value of the assets in each applicable category, there will be an allocation to the sellers of ordinary income or capital gains. Form 8594 must be filed with the IRS by both sellers (the C-corporation and the individual dentist) and the purchaser with their respective Federal Income Tax Returns.

Some advisors have taken the position that the individual/selling dentist should not file a Form 8594 because the sale of goodwill without any other asset does not constitute the sale of a "trade or business." However, the Tax Regulations[33] provide that any sale of a group of assets constitutes a trade or business in the hands of either the seller or purchaser.

In addition, some advisors take the position that the C-corporation has no goodwill so they can make an argument that the IRS cannot increase the corporate goodwill allocation, thereby imposing a double tax. This is a risky strategy, considering the C-corporation is custodian of the patient records and employs a trained workforce![34] If the individual/selling dentist does not file a Form 8594, the allocations won't match with the purchaser's allocations under the purchaser's Form 8594, which could trigger an audit. In addition, there are penalties for not filing under the Tax Code.[35]

Stock Sales

In a complete purchase and sale, no purchaser will purchase stock as it is non-deductible; although it will provide capital gains to the seller. In an asset sale, the purchaser can deduct all assets purchased and the seller receives mainly capital gains because the largest portion of the purchase price, by far, is the goodwill. Stock sales are used in co-ownership or partnerships so that there can be common ownership of the practice entity.

Representations and Warranties

A representation or warranty by the seller is a statement contained within the purchase and sale agreement regarding the status, condition, or some aspect of the practice, its financial condition, or operation. A representation or warranty also may be made by the purchaser regarding the purchaser's financial condition or ability to acquire the practice, e.g., the purchaser is not under a restrictive covenant provision as a result of prior employment within a specified geographic area of the practice being acquired.

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[32] IRC Section 1060.

[33] IRC Reg. Section 1.1060-1.

[34] IRC Section 197 incudes goodwill (personal and corporate), as well as other IRC Section 197 intangible assets such as patient records, trade name, trained workforce, operating systems, and know-how.

[35] IRC Section 6721(e)(2).

Figure 6-1 provides representations and warranties that may be made by the seller in a practice purchase. The representations and warranties are and should be detailed. Figure 6-1 is an example of representations and warranties in which a practice owner is selling stock in the practice. However, if the seller is selling the assets, as opposed to its stock, the representations and warranties should not differ significantly.

Representations and warranties can be made absolute or “to the best of the seller’s knowledge.” For example, Section 1.7 of Figure 6-1 provides that "to the best of Seller’s knowledge, the accounts receivable are fully collectible.” This representation may be acceptable to the purchaser because the seller has no knowledge that the accounts receivable are not collectible. However, in other Sections contained in Figure 6-1, particularly Section 1.9, Tax Matters, and Section 1.19, Litigation, this language may not be acceptable to the purchaser.

The representations and warranties for the purchaser are usually fewer in number than for the seller and usually relate to the purchaser’s ability to enter into an agreement for the purchase of the practice.

Indemnification

In the indemnification provisions, the seller agrees to indemnify or hold harmless the purchaser for any breach of the seller’s representations and warranties and vice-versa. In such a provision, the seller holds harmless or indemnifies the purchaser for any losses or claims arising prior to the closing date of the acquisition and sale. Alternatively, the purchaser indemnifies or holds harmless the seller for any losses or claims arising after the closing date of the acquisition and sale. The provisions can be drafted in a limited or broad manner. The purchaser probably would not agree to indemnify claims of the seller after the closing date relative to the seller providing consulting services or rendering professional services on behalf of the purchaser. Likewise, the seller probably would not agree to indemnify the purchaser prior to the closing date relative to the purchaser working as an employee or independent contractor in the seller’s practice. Indemnification provisions are only as effective as the ability of the indemnifying party to hold harmless or reimburse the other party for the claim in question. However, where the purchaser pays the seller over time, the purchaser may wish to negotiate an “offset” provision against sums owed to the seller. An offset provision places the burden on the seller to institute any litigation against the purchaser for the amount of any offset. Finally, the purchaser and seller may wish to indemnify each other for claims in certain situations above or below a certain monetary or “basket” amount. This amount is subject to negotiations among the parties to the sale and purchase.

Retreatment

The sale and acquisition documents should specifically define the possible problem of “retreatment,” whereby the purchaser would feel obligated to the patient to re-treat work previously completed by the seller. Retreatment can be a very sensitive and emotional concern for both the seller and purchaser. Retreatment can be significant in crown and bridge practices, orthodontic practice sales and purchases, and in general practices where orthodontics, temporomandibular joint (TMJ), or sleep apnea treatment has been provided by the seller. Typically, the seller would not want to pay or indemnify the purchaser for any retreatment and the purchaser would want the seller to complete any retreatment at the seller’s expense. This is a subject of negotiation. Misunderstandings between the seller and purchaser may arise because of failure to consider the retreatment issue.

Letters of Intent

A letter of intent is an optional letter agreement that precedes preparation of the purchase and sale agreements.[36] Letters of intent are prepared by the attorney, advisor, or broker who represents the seller and sometimes by the purchaser's attorney or advisor. Unfortunately, most letters of intent that I have reviewed recently have not adequately delineated the important provisions of the purchase and sale. As a result, the parties often get into disagreements on important terms at the "11th" hour.

Is a Letter of Intent Necessary?

A well-drafted letter of intent considers all key terms and contingencies of the purchase and sale in advance of paying lawyers to draft and review agreements. The following are some recent examples of disagreements over key terms that I have seen:

- A purchaser received multiple draft versions of agreements that had been prepared by the seller's legal counsel and yet the dentists had not agreed on the purchase price.
- A seller was relocating from the Midwest to the South, and there was a disagreement over a 15-mile radius of the restrictive covenant.
- A general dentist/seller would not agree to complete unfinished orthodontic cases, even though the purchaser, who did not perform orthodontic procedures, agreed to make arrangements for and pay the seller to do so.
- An accountant for a purchaser wanted to allocate one-half of the purchase price to dental equipment to obtain favorable amortization at the seller's expense when the equipment was worth roughly 15% of the purchase price.
- A seller insisted on continued full-time employment for 3 years following a sale in which the practice's production was insufficient for two dentists.

Each of these disagreements could have been avoided had a well-drafted letter of intent been prepared, because all important aspects of the purchase and sale would have been discussed with the dentists and advisors. Either all important terms would have been agreed upon or one or both parties would have walked away.

Letter of Intent Provisions

1. The Parties to the Sale and Purchase. The parties to the transaction(s) need to be identified. When the practice is organized as a C-corporation or an S-corporation that was previously a C-corporation for less than 5 years, there will be two sellers, the C-corporation and the dentist who sells his or her personal goodwill. On the purchaser's side, the entity through which the purchasing dentist will practice will be the purchaser, not the individual dentist. If the selling dentist or dentist and spouse own the real estate, the real estate will, hopefully, be owned by a limited liability company. Possibly the members will be a family trust. The purchasing dentist

[36] Prescott WP. Letters of Intent. *Dent Econ.* 2015; 105(11): 58,60.

will, hopefully, also form a limited liability company to purchase any real estate. In the letters of intent that I review, the parties are almost always identified incorrectly.

2. Purchase Price, Payment, and Purchase Price Allocation. The purchase price for any C-corporation's tangible assets and corporate goodwill should be separated from personal goodwill of the dentist/seller.

The collective purchase price is usually fully payable by wire transfer, bank, or certified check at the closing, and terms of any seller financing should be delineated. The purchase price should be reduced by any earnest money deposit, liens on the practice, or brokerage fees paid to a broker. Finally, this provision should provide for the purchase price allocation as designated in a schedule in the letter of intent. The purchase price allocation provides how the seller(s) is taxed on the sale and how the purchaser amortizes or deducts the purchase price, including goodwill, be it corporate or personal, to the selling dentist or specialist.

3. Excluded Assets. Certain items will be excluded from the purchase and sale, such as the seller's accounts receivable (although not always), cash, cash equivalents, retirement plan contributions, any personal items of the selling dentist, and any of the seller's debt, unless specifically assumed by the purchaser.

4. Accounts Receivable. When the accounts receivable are not purchased by the purchaser, the purchaser typically collects the accounts receivable for a period of 6 months following closing, remitting the collected amounts to the seller, less an administrative fee, often 5%.

5. Assets Free and Clear of Liens and Encumbrances. This provision provides that all purchased assets will be free and clear of all liens and encumbrances at closing, unless specifically assumed by the purchaser.

6. Brokerage Fees. This provision provides that all brokerage fees will be the sole responsibility of the seller.

7. Earnest Money Deposit. Letters of intent often provide for an earnest money deposit. In exchange for an earnest money deposit, the purchaser expects the seller to remove the practice from the market until closing, which may be several months in the future. However, it is rare that a purchaser is able to obtain an earnest money deposit sufficiently large enough for the seller to take the practice off the market because the lender uses the practice, not the purchasing dentist, as security. The earnest money deposits that I usually see are roughly $5,000 and would be returned upon the occurrence of certain contingencies. Although the $5,000 does show good faith, my recommendation for an earnest money deposit in this amount is to eliminate it entirely and not take the practice off the market. Another way to handle this is to have a promissory note prepared in a meaningful amount, such as $25,000 or $50,000, and signed by the purchaser. In the event that the purchaser backs out of the transaction, the sum of the promissory note becomes immediately due and payable.

8. Confidentiality. While this provision may appear in a letter of intent, it should have been in an earlier prepared and separate confidentiality letter signed by the purchaser. No purchaser should make an offer on a practice without review of the appraisal and financial information. A confidentiality provision provides that the purchaser will keep the information confidential; however, he or she is permitted to share it with advisors. The purchaser will return all of the information if negotiations cease for any reason.

9. Due Diligence. If this provision is included in the letter of intent, it provides that there will be a specified due diligence period for the purchaser to review the confidential information. If the purchaser or purchaser's advisors are not satisfied with the due diligence investigation, any earnest money deposit or promissory note is returned to the purchaser.

10. Closing. This provision designates that closing will occur on or before a specified date, unless otherwise agreed to by the purchaser and seller in writing.

11. Representations and Warranties. This provision states that the seller will provide the purchaser with customary representations and warranties that will be contained in the purchase and sale agreements.

12. Non-Competition/Non-Solicitation. This provision spells out the time limit and geographic radius or map of the restrictive covenant and non-solicitation provisions for patients and/or referral sources, and former employees of the seller.

13. Post-Closing Employment of the Seller. This provision should provide that, at the purchaser's discretion, the selling dentist will remain employed or engaged as an independent contractor by the purchaser's dental or dental specialty practice for a specified period, e.g., 1 year after closing and by mutual agreement thereafter. Be careful of inappropriate independent contractor relationships because the IRS believes that the selling dentist or specialist is an employee.

14. Financing. This provision provides that the purchase and sale is contingent upon the purchaser obtaining lender financing for the purchase price on or before closing.

15. Lease Assignment, Lease, and Real Estate. This provision provides that the purchaser will obtain a lease assignment or lease for the practice premises on or before closing. If the real estate is owned by the selling dentist and/or spouse or in a separate limited liability company, there may be an option and/or modified right of first refusal for purchase of the real estate at fair market value. There also may be a mandatory purchase of any real estate at a certain point.

16. Death or Permanent Disability. This provision provides that the purchase and sale are contingent upon the purchasing dentist not becoming disabled or deceased prior to closing. A specific definition of disability and selection of a physician is important.

17. Retreatment. This provision provides that the seller is responsible for retreatment of the selling dentist's patients actively treated within the 12 months prior to closing. In the event that the seller and purchaser disagree about the necessity of retreatment for any patient, an arbitrator would be designated, such as another dentist or dental society peer-review committee.

18. Work-In-Process. This provision provides that the selling dentist will be permitted to complete cases started, but not finished, prior to closing. Completion of specialty procedures, such as orthodontics, is also delineated. The seller customarily retains all fees for work-in-process and is responsible for payment of supplies, laboratory fees, and use of any chairside assistant employed by the purchaser. A work in process provision and schedule of cases, patient names, and procedures would be included in the purchase and sale agreements.

19. Mutual Indemnification. This provision provides that the seller and purchaser will hold each other harmless for the operation of the practice prior to and after closing.

20. Definitive Legal Documents. This provision provides that the purchase and sale are expressly contingent on and subject to the preparation of legal documents satisfactory to the purchasing dentist, the selling dentist, and their respective legal counsel.

You tell me. After the examples of disagreements over key terms and the many important provisions that should be considered in the purchase and sale of a practice, isn't a letter of intent important? Once signed by the parties, the lawyer who will draft the purchase and sale agreements prepares them from the letter of intent.

Obtaining Financing

In certain instances, the purchasing dentist will require a loan to not only finance the acquisition of the seller's practice, but later for purposes of expansion and resource management or, in the event that a practice is not purchased, to establish a practice. Whatever the candidate's reasons to borrow money, it is imperative to complete an analysis of the loan repayment in light of anticipated and current revenues, operating expenses, and compensation. In other words, think about repayment of the loan in light of anticipated cash flow before borrowing the money. The lender needs to know the purpose of the loan, the amount of the loan repayment, and the sources of loan repayment. The key factors in obtaining a loan are preparation and sufficient time.

Often, purchasing dentists wait too long to begin the financing process. In preparing an informational package for the lender, consider the following format: projected monthly personal expenses; personal financial statement; projection of the first year's practice operations; practice valuation; the names, telephone numbers, and addresses of the advisors to the transaction; and due diligence reports, financial statements, including year-to-date, and tax returns for the practice over the last 5 years. In addition, any other relevant information, primarily relating to the financial condition of the practice being acquired, is necessary.

Before granting a loan, the lender will review the informational package presented. Usually, if the lender is a bank, a loan committee will grant, conditionally grant, or reject the purchaser's application based on the purchaser's ability to repay the loan, character, and previous repayment history.

Seller-Assisted Financing

Dental lenders did not exist 25 plus years ago. They certainly do now, and they are eager to lend the full selling and purchase price for a dental or dental specialty practice in a complete sale and purchase. An exception is for very large practices in which there will be a component of seller-assisted financing of which terms, to an extent, are negotiable.

In the sale and purchase of a co-ownership or partnership interest, lenders will not lend without a guaranty by the practice and/or existing owner. Generally, my advice is to not provide the guaranty and to finance internally. The reason is if the purchaser leaves, the loan must be repaid. While the buy-sell agreements can provide safeguards, it is simpler to use the internal financing.

Covenants Not To Compete

The primary value of a practice is its patient base. In acquiring a practice, the purchaser does not want the seller to compete after the acquisition is completed, except for those professional services rendered on behalf of the purchaser.

Covenants not to compete include time (e.g., 3 to 7 years), geography (e.g., 10 miles, 20 miles, freeway boundaries, or some defined location, such as a county or communities), non-solicitation of patients and any of the practice's or its employees' referral sources, and trade secrets and confidential information of the practice (e.g., patient lists and/or referral sources).

Employment or Engagement of the Seller after the Purchase

The IRS has made it clear that the selling dentist or specialist remaining with the purchasing dentist's practice after the sale is an employee and not an independent contractor on the basis that the selling dentist or specialist worked for his or her own practice.[37] The selling dentist or specialist wants to be classified as an independent contractor to deduct direct business expenses, insurances, and benefits. The practice will pay less tax if the selling dentist or specialist is an independent contractor rather than an employee. The way around this issue is for the purchaser's practice to reduce the selling dentist's or specialist's compensation by the full cost of the direct business expenses, insurances, and benefits that the selling dentist or specialist would be paid on his or her own, on the basis that the reduction is to calculate the selling dentist's pay. It does not change misclassification if the selling dentist works through his or her existing corporation post-sale.

Although it is an accepted practice for the purchaser to employ the seller in the practice after the acquisition to assist in the transition of patients, the time period necessary to accomplish the transfer is generally shorter than the purchaser expects.

There are two reasons for this limited transition period. First, the seller generally wants to be compensated for professional services rendered in the practice, as well as to be paid for his or her presence on the practice's premises for patient and/or referral source introductions and to answer any of the purchaser's questions. Therefore, the seller is typically compensated with payment for professional services rendered and with an hourly, half-day, or full-day rate for patient and/or referral source introduction and other consulting services for the purchaser. Because the seller is being compensated for professional services, the practice's cash flow is reduced. This limits the purchaser's ability to pay the lender and/or seller the purchase price. The resolution is that the transition period should last only a short time period of 1 to 3 months. In the event that the seller and purchaser plan to work together for more than a short period of time due to the uniqueness of the practice or the seller's desire to continue to work, the impact on cash flow must be considered.

Second, the practice facility size and design often do not allow for the seller and purchaser to render professional services at the same time comfortably. Therefore, for the seller and purchaser to work at the same time, both dentists tend to be somewhat cramped and inefficient.

These comments are generalizations, and exceptions exist. However, for the purchaser to protect himself or herself after the acquisition, relative to the seller's rendering of services, professional or otherwise, the purchaser should retain the ability to limit or terminate the relationship. The seller's purpose should not be to earn a living in the purchaser's newly acquired practice, but to assist in the ownership transition.

[37] American Bar Association, Section of Taxation, Meeting, September 24, 2010, Toronto, Ontario, *Co-Ownership; A Taxing Relationship*; Panel Consisted of Assistant Division Counsel, IRS, Small Business/Self-Employeds and William P. Prescott.

An important exception is that the selling dentist's anticipated retirement may only be partial and not complete. The parties can definitely negotiate that the selling dentist may remain in the practice, even for an indefinite period of time within limitations, to continue to render services on a mutually agreeable basis under agreed-upon schedules, compensation, terms, and conditions. In fact, the selling dentist may negotiate that his or her restrictive covenants become null and void if the purchaser inappropriately terminates the seller's employment after the sale.

Finding Each Other

How do the seller and purchaser find each other? They can meet through (in no particular order) practice brokers; dental schools; dental equipment and supply companies; advertisements in local, county, state, and national dental publications and journals; dental fraternities; dental laboratory technicians; practice management consultants; accountants and attorneys; newspaper classified advertisements; study clubs; colleagues; and/or a combination of any of the above.

Practice brokers sell many of the practices today. Although a brokerage fee of 10% of the selling price is customarily charged, the brokerage fee may be well worth it if the seller cannot find a purchaser or if the candidate/purchasing dentist cannot locate the "right" practice.

Practice Mergers

Practice mergers usually work well for both the selling and purchasing dentist. If the selling dentist is having difficulty locating a purchaser, there is usually a nearby dentist who could be busier. The practice can merge into the most desirable of the two facilities. The economics are usually good in that the overhead of the merging practice is absorbed into the overhead of the ongoing practice. The dental supply representative can be extremely helpful in this situation because the dental supply representative knows who is looking for additional patients.

Summary

Practice sales and acquisitions work well when the parties and their advisors understand all of the relevant factors relating to the transaction. When the sale and acquisition are a "win-win" for both the selling and purchasing dentist, the sale and acquisition are usually successful.

Figure 6-1

REPRESENTATIONS AND WARRANTIES

1. Representations and Warranties of Seller. Seller hereby represents and warrants to Purchaser as follows:

1.1 Organization. The Practice is a professional corporation duly organized, validly existing, and in good standing under the laws of the State of _____, has full corporate power and authority to own all of its property and assets and to carry on its dental practice as it is now being conducted.

1.2 Authorized Agreement. All corporate action by the Practice necessary for the authorization and consummation of the transactions contemplated hereby has been taken.

1.3 Valid and Binding Agreement. This Agreement has been validly executed and delivered by and constitutes a valid and binding obligation of Seller enforceable in accordance with its terms.

1.4 Ownership of the Practice. Seller owns beneficially and of record one hundred percent (100%) of the shares of the Practice's issued and outstanding capital stock, free and clear of all liens, claims, encumbrances, or restrictions of any kind, which constitutes the "Shares." Each of the Shares has been duly authorized and validly issued and is fully paid and nonassessable. The Practice has outstanding no other equity securities, or any securities options, warranties, or rights of any kind convertible into equity securities of the Practice.

1.5 Financial Statements. Seller has delivered to Purchaser copies of the Practice's financial statements for the fiscal year ended _____ (herein called the "Financial Statement Date"), and for the fiscal year ended on _____, of each of the years _____ and _____ and notes thereto and the Practice's "Interim Financial Statements" for the period _____ through and including _____ (all of which statements are herein collectively called the "Financial Statements"). The Financial Statements have been prepared on a compilation basis and are true, complete, and correct, have been prepared from the books and records of the Practice on a comprehensive basis of accounting, consistently applied for the periods indicated, and that present fairly the financial position and results of operations of the Practice as of the dates thereof and for the periods covered thereby. There are no facts known to the Seller that would materially alter the information contained in the Financial Statements.

1.6 Inventory. The Practice dental supply inventory and dental instruments are merchantable, suitable, and usable in the ordinary course of the Practice business and operations. The Practice assets include a sufficient (but not an excessive) quantity of each type of such dental supplies and instruments in order to meet the normal requirements of the Practice's business and operations.

1.7 Accounts Receivable. All accounts receivable of the Practice are valid and enforceable. To the best of Seller's knowledge, the accounts receivable are fully collectible.

1.8 Liabilities. Except as disclosed in the Financial Statements or on Schedule 1.8 (attached hereto and incorporated herein by reference), the Practice has no debts, liabilities, or obligations of any nature whatsoever, whether accrued, absolute, contingent, or otherwise. All

Figure 6-1

deposits, accounts and notes payable, and other liabilities of the Practice are current and not in default.

1.9 Tax Matters. The Practice has timely and duly filed with the appropriate governmental agencies all tax reports and returns required to be filed by it. All of such reports and returns are true, correct, and complete for the periods covered thereby. The Practice has timely and duly paid all taxes required to be paid by it in respect of the periods covered by such returns. All deposits required by law to be made by the Practice with respect to employees' withholding taxes have been duly and timely made. True and complete copies of all federal income tax returns on Forms 1120 for the tax years ending _____; _____; and _____ as filed with the Internal Revenue Service have been delivered to Purchaser, together with all supporting schedules thereto. There are no federal, state, or local tax liens upon any property or assets of the Practice. The Practice has not requested any extension of time within which to file any tax returns that have not since been filed, and no deficiencies for any tax, assessment, or governmental charge have been claimed, proposed, or assessed by any taxing authority, and there is no basis for any such deficiency or claim. As used herein, the term "tax" includes (but is not limited to) all federal, state, and local income, sales, employees' income withholding, social security, franchise, property, and all other governmental taxes, fees, and charges.

1.10 Title to and Condition of Property. The Practice has good and marketable title to and rightful possession of all assets it owns, except assets sold or otherwise disposed of in the ordinary course of the Practice business and operations, free and clear of all liens, security interest, encumbrances, and restrictions, except: (i) liens for current taxes not yet due and payable; and (ii) liens or encumbrances described in Schedule 1.10 (attached hereto and incorporated herein by reference). Purchaser acknowledges that Seller is making no representation or warranty with regard to the condition or use of the assets of the Practice, except as expressly set forth in this Agreement.

1.11 Compliance with Law. The Practice has been and is being conducted in compliance with all applicable federal, state, and/or local laws, rules, regulations, and orders, non-compliance with which would have a material and adverse effect on the Practice, its business, and operations, or its assets.

1.12 Insurance. Schedule 1.12 (attached hereto and incorporated herein by reference) lists all insurance policies maintained by the Practice, showing the types of coverage, policy expiration dates, policy numbers, and policy limits as to each such policy. All such policies pursuant to which coverage exists are in full force and effect and have been issued under valid policies for the benefit of the Practice by insurance carriers licensed to do business in _____. The consummation of the transactions contemplated hereunder shall not cause the termination or cancellation of any such insurance policy.

Figure 6-1

1.13 Contracts and Leases. Except as disclosed on Schedule 1.13 (attached hereto and incorporated herein by reference), the Practice is not a party to any written or oral contract, lease, or commitment. All agreements listed in Schedule 1.13, to the extent that the same grants rights to the Practice, are enforceable by the Practice and the Practice has not received notice of any claim to the contrary. Each agreement listed in Schedule 1.13 is in full force and effect, constitutes a legal, valid, and binding obligation of the respective parties thereto, enforceable in accordance with its terms, except as indicated in Schedule 1.13. Complete and correct copies of all written items listed in Schedule 1.13 have been made available to Purchaser prior to the execution of this Agreement.

1.14 Defaults. Except as listed in Schedule 1.14 (attached hereto and incorporated herein by reference), all parties obligated under the agreements listed on Schedule 1.13 are in compliance in all material respects with the terms thereof and there has been no notice of default or termination.

1.15 Transactions with Seller. Except as disclosed on Schedule 1.15 (attached hereto and incorporated herein by reference), the Practice does not owe any amount to, or have any contract with or commitment to Seller (other than compensation for current services not yet due and payable and reimbursement of expenses arising in the ordinary course of business), and Seller does not owe any amount to the Practice.

1.16 Employee Benefit Plans. Except as disclosed on Schedule 1.16 (attached hereto and incorporated herein by reference), the Practice has not and does not sponsor, maintain, or contribute to any employee pension benefit plans within the meaning of Section 3(2) of the Employee Retirement Income Security Act of 1974 (ERISA) or any other program or arrangement under which the Practice has any obligations in respect of, or that otherwise cover, any of the current or former employees of the Practice, or their beneficiaries. Each terminated qualified retirement plan (within the meaning of Section 401(a) of the Internal Revenue Code), herein called the "Terminated Plan,": (a) has received a favorable determination letter from the Internal Revenue Service with respect to its termination; and (b) was terminated in accordance with all applicable federal, state, and local laws, rules and regulations. In addition to and not in limitation of the indemnification provisions contained in Section _____ hereof, Seller hereby agrees to indemnify and forever hold harmless Purchaser, individually and jointly, from and against any and all actions, causes of action, liabilities, damages, penalties, costs, and expenses (including, but not limited to, attorneys' fees) directly or indirectly arising from or related to the Terminated Plan.

1.17 Other Employee Matters. Except as disclosed in Schedule 1.17 (attached hereto and incorporated herein by reference), the Practice has no plans and/or policies with respect to vacation pay, holiday and/or sick pay, pension and profit-sharing contributions, health, medical, or any other type of employee welfare benefit plan within the meaning of Section 3(1) or ERISA to which the Practice presently contributes or is required to contribute, nor is the Practice indebted to any employee other than for wages and benefits earned during the current payroll period that are not yet due and payable. Except as set forth on Schedule 1.17, there are no controversies pending between the Practice and any of its employees, which controversies have affected or may affect materially and adversely the business, operations, assets, prospects, or condition (financial or otherwise) of the Practice.

Figure 6-1

1.18 Absence of Certain Changes. Except as set forth in Schedule 1.18 (attached hereto and incorporated herein by reference), during the period from the Financial Statement Date to the Closing Date, the Practice has not and will not have:

(a) Experienced any change in its business, financial condition, or operations that may have any material adverse effect on the Practice, its financial condition, its operational results, or patients; or

(b) Incurred any obligation or liability, except current (liabilities incurred in the ordinary course of business and consistent with its prior practice;

(c) Failed to replenish its inventory of dental supplies and instruments in a normal and customary manner consistent with its prior practice;

(d) Created or suffered to exist any lien, claim, or encumbrance with respect to its assets;

(e) Sold, transferred, or otherwise disposed of any assets or properties of the Practice other than in the ordinary course of its business;

(f) Forgiven or cancelled any debts or claims, or waived any contractual or other rights; or

(g) Otherwise conducted its business or entered into any transaction, except in the usual and ordinary manner and in the ordinary course of its business.

1.19 Litigation. No litigation or other judicial, administrative, or investigative proceeding is pending or threatened against or affect the Seller, the Practice, or its assets.

1.20 Consents. To the best of Seller's knowledge, no consents or approvals of any third party are required or will be required in order to permit the consummation of the transactions contemplated by this Agreement.

1.21 Permits and Licenses. Schedule 1.21 (attached hereto and incorporated herein by reference) sets forth all licenses and permits issued by applicable governmental authorities presently held by the Practice with respect to the operation of its business. Seller has not received notice of any violations with respect to any of such license or permits.

1.22 Bank Accounts. Set forth in Schedule 1.22 (attached hereto and incorporated herein by reference) is an accurate and complete list, disclosing the name and address of each bank in which the Practice has an account or safe deposit box, the number of any such account or any such box and the names of all persons authorized to draw thereon or to have access thereto.

1.23 No Guaranties. None of the obligations or liabilities of the Practice are guaranteed by any other person or entity, nor has the Practice guaranteed the obligations or liabilities of any other person or entity.

1.24 Title to the Assets or Shares. Seller has valid and unencumbered title to the Shares, free and clear of all restrictions, liens, and encumbrances, and has full legal right, power,

Figure 6-1

and authority to enter into this Agreement, to sell, assign, transfer, and deliver the Shares hereunder, and to perform his other obligations under this Agreement. Upon delivery of and payment for the Shares, Purchaser shall acquire title thereto, free and clear of all liens, restrictions, or encumbrances.

1.25 Correctness of Representations and Warranties. The representations and warranties made by Seller herein or in any certificate to be furnished to Purchaser or Purchaser's counsel pursuant hereto, or in connection with the transactions contemplated hereby, do not contain and, at the Closing, shall not contain any untrue statement of a material fact and do not omit and shall not omit to state all material facts necessary to make the statement or facts contained therein not misleading. All statements made and data presented by Seller in this Agreement and in any certificate or schedule provided to Purchaser by Seller pursuant hereto shall be deemed to be representations and warranties under this Agreement to Purchaser by Seller.

Chapter 7

ACQUIRING YOUR PRACTICE — THE IMPORTANCE OF PURCHASER DUE DILIGENCE

Due diligence has been defined as "such measure of prudence as is properly to be expected from and ordinarily exercised by a reasonable and prudent man under the particular circumstances, not measured by any absolute standard, but depending on the relevant facts of the special case."[38]

The purpose of the due diligence or purchase investigation is to determine whether the acquisition should be made and, if so, to determine the purchase price, terms, and conditions of the proposed transaction, irrespective of a complete purchase and sale, co-ownership, or other practice entry choice. The due diligence or purchase investigation is the legal, accounting, and business homework that is necessary to ensure that you are actually receiving what you are paying for regarding the purchase of a particular practice. You and your advisor(s) should review, question, and probe the disclosure schedules that would be completed by the seller and/or the seller's advisor(s).

The closer you become to making an informed decision to acquire all or a portion of a particular practice, the more critical the due diligence process becomes. One method of analyzing the due diligence process is to categorize it into three components: comparison of your practice options, preparation or confirmation of the proposed acquisition (practice valuation, business and tax structure, and terms), and confirmation that you are actually receiving what you think you are purchasing.

A big part of the due diligence is the determination of the percentage of patients or referral sources that will remain with your practice. If 90% of patients remain, as opposed to 100%, this is a significant factor in determining practice value. In addition, there is a trend for the seller not to inform staff that a complete purchase and sale will take place and brokers usually will not permit staff interviews prior to closing of the sale. If key staff will not remain with your practice, how does this affect your revenue and profitability? I recently spoke with a dentist who purchased a general practice where staff was not informed of the pending sale. After the sale, one hygienist retired and another left to work at a competing practice. These are risks that affect what you should pay for a particular practice.

Comparison of Practice Options

It is advisable to compare your options for entering practice in light of the available opportunities within the specified geographic area(s) where you intend to practice, your personal goals, and your financial situation. This form of homework takes place on a personal level and with the least economic/advisory cost to you, depending on the amount of effort that you are willing to put forth.

Preparation or Confirmation of the Practice Valuation

The second category of the due diligence process is the preparation or confirmation by you and/or your advisor(s) of the practice valuation in light of the revenue and profitability of the particular

[38] Black HC. *Black's Law Dictionary*. 5th ed. St. Paul, MN: West Publishing Company; 1979:411.

practice. Although numerous practice characteristics exist that impact practice value (e.g., percentage of active patients in a recall program to total number of active patients for a general practice, number of new patients per month, percentage of practice in fee-for-service, etc.), all such characteristics affect both revenue and profitability in some way over the long term.

As part of this process, it is essential for your CPA to prepare a budget of your anticipated practice revenue and operating expenses in light of the historical data relative to the practice, anticipated future events, and expenditures. For example, a future event and expenditure would be an anticipated relocation of the practice with the corresponding costs (e.g., plumbing, electrical, carpentry, decorating, and equipment replacement costs). Such costs should be anticipated as part of the homework process to ensure that the requested purchase price of the practice is fair to both you and the seller. Without the proper homework on your part (and your advisor(s)), you cannot assess the cash flow that you will incur in your newly acquired practice.

Therefore, the second category of the due diligence process is to prepare or confirm the value of the particular practice. However, to do so, it is imperative that your accountant prepares a verification analysis so that after the acquisition, based on historical practice data, you will expect to earn a reasonable living, pay the operating expenses that you will incur in the practice, and pay the lender(s) the purchase price for the practice, all within a measured time period not to exceed 7 years, regardless of the term of your loan.

The more complete, accurate, and reliable the information you have to value the practice or to assess the accuracy of an existing valuation, the easier it will be for you to make an informed decision whether to proceed with a particular acquisition. Assuming that it is your intention to purchase a particular practice, it is critical to obtain relevant information about it in order to determine or confirm the purchase price and terms. Figure 7-1 is a due diligence checklist for you to use. The items indicated by an asterisk are those that should be requested from the seller or seller's accountant to prepare or confirm the valuation report.

Item E.6 of Figure 7-1 provides for a written analysis of the geographic and area demands for a dentist/specialist. In preparing this report, list the number of dentists/specialists in the geographic area where you intend to practice, the number of people living in the area, and the income, age, and demographic trends of the area population. Because some areas will grow and others will decline, you should assess your economic ability to meet your revenue projections in light of your operating expenses over the long term.

At the time that the practice valuation is being prepared or confirmed, you are not yet in the final, or "in depth," stage of the due diligence process. Although the second category or level of due diligence is detailed, you have not yet made the decision to acquire this particular practice. Once that decision is made, the final component or most detailed level of due diligence takes place.

Confirmation of Value

Confirmation of value or attempting to ensure that you are really receiving what you are paying for is the traditional form of due diligence.

The Due Diligence Checklist provided in Figure 7-1 contains the information that you and your advisor(s) should request and review relative to the practice being acquired. While not every category contained in the Due Diligence Checklist will be applicable to each acquisition, it is surprising how much information about the operation of a particular practice is taken for granted

without appropriate review. The more homework that you and your advisor(s) do relative to the purchase investigation, the greater your chances of a successful acquisition.

One method to assess the due diligence process, its three (3) categories, is by way of two types of factors; those economic in nature, and those with regard to minimizing the legal risks associated with practice ownership.

The economic and risk factors can be measured against the classifications described in Figure 7-1: Compatibility of Purchaser and Seller, Financial Information, Practice Facility, Lease and Real Estate Matters, Operational Matters, Employment Relations and Benefits, Litigation—Pending/Threatened, and Organizational Matters.

Compatibility of Purchaser and Seller

Irrespective of how favorable the operational and financial results of a particular practice are, you and the seller should be compatible in your ethics and philosophy relative to the profession of dentistry or your specialty. To assess your compatibility, you and the seller should spend the appropriate amount of time together to determine the extent that you share similar practice values.

Financial Information

Much of the financial information relative to the particular practice and its operational results is obtained prior to preparation or confirmation of the practice valuation. The financial information should be reviewed to ensure that it is accurate, consistent, and complete, as your decision to acquire a particular practice will primarily be based on its historical financial data. In this regard, the seller is typically asked to make certain representations and warranties regarding the financial information. The representations and warranties would be provided in the sale and acquisition documents.

Review the aging of the accounts receivable and the historical collection rate of the practice. A practice may have a significant amount of uncollectable accounts receivable that have never been written off and have accumulated over a long period of time. Therefore, accounts receivable are an important area for your review, regardless of whether you acquire the accounts receivable or pay them to the former owner as they are collected.

Practice Facility

The necessity for due diligence concerning the practice facility is based on the need for future renovations, a possible relocation, an expansion, or replacement of dental equipment, office equipment, computer equipment, and/or furniture. For example, unless maintenance records for dental equipment are examined or the dental supply dealer (yours, the seller's, or both) completes a thorough maintenance inspection, you will not easily be able to assess future expenditures. These expenditures will impact your practice cash flow and compensation after the acquisition.

Lease and Real Estate Matters

In acquiring a particular practice, you will obtain a lease, or lease assignment, for the premises of the practice; purchase the premises, land, and building/condominium; or negotiate an option and/or right of first refusal to purchase said premises at a future date as either a part of the lease or in a separate document. As such, it is critical that certain homework be completed regarding environmental matters, easements, zoning, etc.

Operational Matters

Homework on practice operations is important to assess the practice's growth, stability, and quality of professional services.

For example, you need to review the patient charts. Too often, purchasing doctors do not appropriately review the appointment book and all patient charts prior to the acquisition. Unless you review the charts, you cannot assess critical characteristics of the patients and procedures performed by the practice.

Employment Relations and Benefits

In acquiring a practice, it is important to assess the manner in which the staff interacts with each other, as well as with the practice owner(s). You need to know which employees you wish to retain in the practice after its acquisition and whether such employees intend to remain in the practice, the quality of their performance, their compensation levels, and their benefits. For example, if the current owner(s) funds a substantial retirement contribution on behalf of rank and file employees, your cash flow during your early years as a practice owner may be correspondingly reduced. However, you may wish to retain the goodwill of staff members, irrespective of whether you have sufficient cash flow to sustain the current level of benefits. It is this type of information that is evaluated as part of the homework process. This type of information also may impact the purchase price that you would be willing to pay for a particular practice.

Litigation — Pending/Threatened

If there is any potential, pending, or threatened action, investigation, complaint, audit, or litigation that may affect you as the new owner of the practice, you need to know about it. You are acquiring a practice, not its problems—current, past, pending, or threatened. The representations and warranties that the seller and/or professional corporation would be asked to make about the practice would include those relating to litigation.

Organizational Matters

The homework on organizational matters typically relates to the acquisition of a professional corporation or limited liability company. You need to know that the formalities required by state and federal laws are complied with so that you do not become potentially liable for any liabilities of the practice being acquired or of its owner(s).

Summary

Generally, due diligence or purchaser homework is not given sufficient attention. I believe it is because the purchasing candidate may not think that the cost is worth the benefit. But think of the due diligence investigation as a form of risk management. If the incoming dentist is successful in the practice purchase or partnership, wonderful. If not, almost all problems or risk factors can be identified in advance and assessments can be made.

Figure 7-1

DUE DILIGENCE CHECKLIST[39]

*** Designates that the due diligence information should have been requested, reviewed and used as part of the preparation or confirmation of the practice valuation.**

Completed	Not Completed	Inapplicable		
			A.	**Compatibility of Purchaser and Seller**
_____	_____	_____	*1.	Contrast seller'(s) practice mission and philosophy to yours;
_____	_____	_____	*2.	Contrast seller'(s) personal values and work ethic to yours;
_____	_____	_____	*3.	Assess seller'(s) reason for departure from active practice;
_____	_____	_____	4.	Assess reputation of the practice and practice owner(s) within the community and among colleagues; and
_____	_____	_____	5.	Assess willingness of seller(s) to transfer ownership of the practice.
			B.	**Financial Information**
_____	_____	_____	*1.	Obtain federal income tax returns of the practice for the lesser of the last five fiscal years or the number of years in practice;
_____	_____	_____	*2.	Obtain financial statements and balance sheets (assuming that they are prepared for the practice) for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;
_____	_____	_____	*3.	Obtain an aged trial balance of all practice accounts receivable and the historical practice collection records for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

[39] Prescott WP. *The Practice Acquisition Handbook*. Naples, FL: Randall K. Berning and Affiliates; 1997:App. I.

Figure 7-1

_____ _____ _____ 4. Obtain appropriate certificates of payment from state authorities evidencing proper payment of or provision for sales taxes, workers' compensation premiums and unemployment compensation premiums;

_____ _____ _____ 5. Obtain list of bank accounts and lenders for the practice;

_____ _____ _____ 6. Obtain copies of any equipment lease and/or loan agreements or line of credit agreements with lenders for the practice and a list of those individuals guaranteeing said agreements;

_____ _____ _____ 7. Obtain specific amounts of gross production and collections by individual doctor and hygienist(s) for the lesser of the last five fiscal years or the number of years in practice and the current year to date;

_____ _____ _____ 8. Obtain listing of all accounts receivable written off and/or sent to any collection agency or attorney in each of the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date; and

_____ _____ _____ 9. Obtain itemized list of all leasehold improvement costs made in the current practice facility and the date(s) said leasehold improvements were made.

_____ _____ _____ 10. Your accountant should prepare your financial budget for the practice being acquired.

_____ _____ _____ 11. Your accountant should assist you in the preparation of your personal financial statement to assess your current financial situation and ability to obtain financing for the purchase price of the practice.

C. <u>Practice Facility</u>

_____ _____ _____ *1. Obtain floor plan of the practice facility;

_____ _____ _____ *2. Obtain an itemized list and the fair market value of all dental equipment being acquired by treatment room, plus darkroom, utility room, sterilization area, x-ray area and laboratory;

Figure 7-1

_____ _____ _____ *3. Obtain an itemized list and the fair market value of all office equipment and furniture being acquired;

_____ _____ _____ *4. Obtain an itemized list and the fair market value of all tangible assets, personal and other items located in the practice facility not being acquired;

_____ _____ _____ *5. Obtain an itemized list and the fair market value of all tangible assets (dental equipment, office equipment and furniture) leased by the practice or located in the practice facility to which the practice does not hold clear title;

_____ _____ _____ *6. Obtain maintenance records for all dental and office equipment from the date of purchase through the current date;

_____ _____ _____ 7. Assess overall appearance, aesthetics and condition of practice facility;

_____ _____ _____ 8. Determine whether dental equipment is right or left handed in light of your ability to practice comfortably and efficiently;

_____ _____ _____ 9. Review your ability to expand the current practice facility; and

_____ _____ _____ 10. Assess current parking availability.

D. <u>Lease and Real Estate Matters</u>

_____ _____ _____ *1. Obtain copy of any current lease, any renewal amendments and any document evidencing recording of the lease;

_____ _____ _____ *2. Obtain copies of any deed, documents and/or agreements relating to the practice owner's (or family members') ownership of the practice real estate;

_____ _____ _____ 3. Obtain copies of any surveys, plans, blueprints, specifications and other technical documents relating to the practice real estate, improvements, sewerage, etc.;

Figure 7-1

_____ _____ _____ 4. Obtain copies of any environmental or other regulatory permits, proceedings, abatement proceedings or any other regulatory matter affecting the practice real estate;

_____ _____ _____ 5. Obtain copies of any title insurance policies and environmental audits relative to the practice real estate;

_____ _____ _____ 6. Obtain copies of any contracts to sell, purchase or lease the practice real estate;

_____ _____ _____ 7. Obtain copies and/or list of any insurance policies for the practice real estate;

_____ _____ _____ 8. Obtain list of any zoning, public health, building code or other violations for the practice real estate for the lesser of the last five calendar years or the number of years the seller owned the practice real estate and the current year to date; and

_____ _____ _____ 9. Obtain list of any material easements, licenses or other rights-of-way granted relative to the practice real estate.

E. <u>Operational Matters</u>

_____ _____ _____ *1. Obtain number of active patients (patients treated in the past twenty-four consecutive months), as well as the number of inactive patients (those patients not having any dental services rendered within the last twenty-four consecutive months);

_____ _____ _____ *2. Obtain a summary of the number of new patients in each consecutive month for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

_____ _____ _____ *3. Obtain the number of the current patients (and percentage of the practice) in recall, if applicable;

_____ _____ _____ *4. Obtain a current fee schedule and a summary of fee increases for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

Figure 7-1

_____	_____	_____	*5.	Obtain a specific list of those procedures performed by the practice and those referred to specialists, if applicable;
_____	_____	_____	*6.	Provide your written evaluation of the area demand and potential for economic growth for a dentist/specialist in the geographical area where you intend to practice;
_____	_____	_____	7.	Obtain reports demonstrating practice compliance with OSHA and State Dental Board Regulations;
_____	_____	_____	8.	Assess stability of the practice and surrounding community;
_____	_____	_____	9.	Assess competition in the geographical location of the practice;
_____	_____	_____	10.	Assess practice location;
_____	_____	_____	11.	Review demographic characteristics of patients (location, age and income);
_____	_____	_____	12.	Determine availability of seller assisted financing;
_____	_____	_____	13.	Determine the number of hours and days worked per month by the dentist(s)/hygienist(s);
_____	_____	_____	14.	Determine the amount of time taken off by the practice owner yearly;
_____	_____	_____	15.	Determine the number and percentage of patients in the practice covered by insurance/managed care/Medicaid/other;
_____	_____	_____	16.	Assess availability of public transportation;
_____	_____	_____	17.	Review all current patients' charts, manner of payments, patient demographics, etc.;
_____	_____	_____	18.	Review quality of the manner in which patient records and charts are retained in the practice;
_____	_____	_____	19.	Review effectiveness of management systems;
_____	_____	_____	20.	Review entity type/completeness of legal and accounting records;

Figure 7-1

_____ _____ _____ 21. Obtain list of all contracts or other agreements to which the practice is a party;

_____ _____ _____ 22. Obtain copies of all insurance policies for the practice;

_____ _____ _____ 23. Obtain copies of any current third-party payment contracts;

_____ _____ _____ 24. Obtain copies of all licenses, permits, registrations, certificates, consents, accreditations and approvals needed to conduct the operation of the practice;

_____ _____ _____ 25. Obtain list of all names, trade names, d/b/a, etc. used in the practice for the lesser of the last five fiscal years or the number of years in practice;

_____ _____ _____ 26. Obtain copy of any broker, finder or other contract requiring the payment of a fee in connection with the sale of the practice;

_____ _____ _____ 27. Calculate the current percentage of case acceptance rate as a percentage of all cases presented for treatment in the practice; and

_____ _____ _____ 28. Obtain copies of any shareholder or member operational agreements (e.g. buy/sell agreements, deferred compensation agreements, employment agreements or close corporation agreements, etc.);

F. <u>Employment Relations and Benefits</u>

_____ _____ _____ *1. Obtain a census of all employees of the practice, the hours worked, compensation levels, positions, responsibilities and dates of hire (including former employees) for the lesser of the last five fiscal years or the number of years in practice and the current fiscal year to date;

_____ _____ _____ *2. Obtain copies of all employee handbooks, job descriptions and/or other publications distributed to employees of the practice;

_____ _____ _____ 3. Obtain copies of all employee benefit plans (and summary plan descriptions) for the practice, including defined benefit, defined contribution, medical, severance, sick pay, vacation,

Figure 7-1

retirement or any other plan, whether or not included in a formal plan;

_____ _____ _____ 4. Obtain copies of all IRS determination letters and similar governmental approvals and filings for any employee benefit plans;

_____ _____ _____ 5. Obtain all recent actuarial reports relating to employee benefits, if applicable;

_____ _____ _____ 6. Obtain list of all insurance plans relating to employees of the practice;

_____ _____ _____ 7. Obtain list of all employment discrimination claims of the practice and/or any other employee claims or disputes against the practice for the lesser of the last five fiscal years or the number of years in practice and current fiscal year to date;

_____ _____ _____ 8. Obtain specific details relating to any doctor(s) formerly working in the practice since its inception; and

_____ _____ _____ 9. Assess feasibility and likelihood of each staff member remaining with the practice after the ownership change.

G. <u>Litigation — Pending/Threatened</u>

_____ _____ _____ 1. Obtain copies of pleadings for any pending litigation, arbitrations, grievances, other judicial or administrative proceedings;

_____ _____ _____ 2. Obtain list of any pending and threatened litigation since the inception of the practice relating to litigation, claims and assessments;

_____ _____ _____ 3. Obtain description of all outstanding judgments, assessments, penalties or fines;

_____ _____ _____ 4. Obtain list and copies of all demand letters, notices or claims received within the lesser of the last five years or the number of years in practice; and

_____ _____ _____ 5. Obtain copies of any audits performed or other governmental filings relative to the practice, including, but not limited to, ERISA and

Figure 7-1

employee benefits/Department of Labor, State Dental Board, OSHA, Internal Revenue Service or State Department of Taxation since the inception of the practice.

H. <u>Organizational Matters</u>

_____ _____ _____ 1. Obtain charter and all amendments certified by the State;

_____ _____ _____ 2. Obtain articles of incorporation or organization certified by corporate officer or member, if applicable;

_____ _____ _____ 3. Obtain list of current directors and officers (or members and managers);

_____ _____ _____ 4. Obtain list of shareholders/members and shares/units owned;

_____ _____ _____ 5. Obtain current stock or membership transfer records, certificates and shares or units owned;

_____ _____ _____ 6. Obtain record of directors' and shareholders' (or members') actions since the inception of the practice (e.g., corporate record book); and

_____ _____ _____ 7. Obtain all professional annual reports for the lesser of the last five fiscal years or the number of years in practice.

Chapter 8

SELLING TO A CORPORATE PRACTICE

Several years ago, most dentists did not do well in the dental service management company (corporate practice) market through initial public offerings.[40] In fact, some were placed in the position of having to reacquire their practices. Now, corporate practices are back in a significant way and are organized into various forms: some very large with many locations, some small, some 100% dentist owned, some partially non-dentist owned, some only non-dentist owned, and some offering venture capital opportunities.[41] Unlike the last round, I see corporate practices in the market to stay.

Before selling your practice to a corporate practice, consider the following. First, get paid in cash. Corporate practices usually pay most of the purchase price at closing with a holdback amount to be paid in a year, based on practice performance. And the performance requirements only become more complicated when an associate is involved, particularly if the associate quits. If you agree to a holdback, the corporate practice will not agree for its owners to be personally liable to you. This means that there is a risk of nonpayment if the corporate practice becomes insolvent or is reacquired.

Negotiate the period of time that you would be required to work for the corporate practice and under what terms. Several years ago, the corporate practices were requiring that you work for them for 5 years. Now I see that the time period is, on average, 2 years. However, if you are unhappy working for your new employer, 2 years can be a long time. Try to negotiate your ability to terminate your employment through a notice provision if you are unhappy, such as 90 or 100 days' notice at most. Yes, the restrictive covenant that you agreed to holds up with rare exceptions.

Negotiate how you are paid, as well as other terms of your employment. Generally, retired general dentists working for corporate practices are paid 25% of collections, and specialists are paid a higher percentage. Are you better off working 2 more years and closing the doors or selling to another dentist rather than selling to a corporate practice? With the sale to the dentist, you won't be required to work for the 2 years and you would be paid at a much higher rate if you did. If you sell to a corporate practice, you should negotiate a minimum monthly compensation rate. Also, you should include a provision that your new schedule will be substantially similar to your schedule before selling your practice, ahead of any new associate hired by the corporate practice.

You really need to do your due diligence or seller homework on the corporate practice proposing to buy your practice. In a recent situation, a retired doctor wanted out of his 2-year commitment to the corporate practice because they paid the non-doctor staff at a significantly lower percentage of practice collections than he and his partner did. His comment was "I cannot perform professional services at our level of quality paying the staff at a significantly reduced rate. The staff won't stay."

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[40] Pride JR, Prescott WP. Who's the Boss? *Dent Econ.* 1998; 88(3): 16,19,22-24.

[41] Prescott WP. Group practice: Look before you leap, especially into a nontraditional group (Part 1). *Dent Econ.* 2017; 107(7): 26-28.

Make sure that you can live with the representations and warranties that you are being asked to agree to. Can you guarantee that your staff will remain with the corporate practice? What if the corporate practice reduces staff pay and benefits, which is not uncommon? Can you guarantee patients will remain or that referral sources will continue to refer? No, you cannot!

What about your building or condominium unit? Is the corporate practice willing to purchase it at closing or at some future time? The corporate practice will not provide personal guarantees, and you have little security for the promise that the corporate practice will purchase your real estate at a later date. If you are leasing your facility to the corporate practice, are they granting personal guarantees as a tenant? Probably not.

Can you practice in accordance with the policies of the corporate practice? Better know about this up front.

How is the corporate practice doing financially? At what rate are they opening or buying practices, and how are their practices performing?

Are you on the hook if the corporate practice relocates and spends substantial sums on a build-out, equipment, and technology?

Do not invest in a corporate practice. You will have a minority interest with all the associated risks beyond your control.

Last, what about your state's dental board? Are there risks to your license if you sell your practice to a corporate practice where there may be non-dentists as owners?[42] Think states aren't looking at this? If your state's dental board is good with the sale, you and the corporate practice should have some comfort. If your state's dental board does not approve the sale, run!

Summary

Take precautions when selling to a corporate purchaser. It is not the same as a sale to a private dentist.

[42] Walker B, Lawley LR, Del Rio AM. Evolving regulation of dental services organizations: Regulatory update. *Dent Econ.* 2016; 106(11): 12, 14-15.

Chapter 9

HIRING OR BECOMING THE ASSOCIATE

Why would a practice owner hire an associate? Among the reasons are the practice owner needs someone to ease the burden of an extremely busy life and provide coverage for time off. In addition, the practice owner might need another dentist to practice with, meet patient and/or referral demand for professional services, and buy him or her out upon retirement or other departure from practice. Will an administrative profit be made from the associate? Hopefully! However, there may not be enough practice productivity and profitability to both pay the associate and earn an appropriate and administrative profit of 10% plus. On top of this, the facility may not have enough square footage to accommodate the practice owner, the hygienist(s), and the associate. Additionally, the practice owner must take time from patients to mentor and train the associate in what may be a 1½-dentist practice. Because a sufficient patient demand is essential, if a practice owner has a 1½-dentist practice, the owner should reconsider hiring an associate. Do not make the mistake of thinking that the associate will increase the owner's 1½-dentist practice into a 2-dentist practice. Time and time again, it does not turn out well.

Why would a new dentist want to become an associate? The new dentist may not be able to establish his or her own practice with a filled schedule for a significant period of time. The new dentist also will probably lack confidence and require the mentorship of a seasoned dentist or specialist.

Do associate arrangements work? Yes. They can and should work with sufficient patient and/or referral demand. The practice owner may need relief from stress, and an associate can truly help ease the burden of a busy practice with potential for growth. The practice owner would typically be pleased to train his or her successor, knowing who will treat the practice's patients upon his or her retirement. The practice owner also would like to know that he or she will be welcome to treat patients on a limited basis after "official" retirement, unless the retirement will be complete and not partial.

Personality Profiling

From each dentist's perspective, compatibility will be a key to a successful long-term relationship. In this regard, personality testing and profiling is available to assess personality types and compatibility. These testing procedures and tools are effective, inexpensive, and easy to use. They are a starting point for assessing compatibility over the long term. It is tried and tested that certain personality types work well with one another and others do not. Staff personalities and those of the dentists' spouses also are significant to determine whether the working relationship will be successful in the practice. At a minimum, personality profiling can be a tool whereby the practice owner and associate can discuss their working relationship, philosophical values, personality types, and work philosophies. However, personality profiling is not foolproof and does not measure effort and desire. Neither the practice owner nor the associate know how the relationship will work until it is time tested by associate employment with monitors to judge progress.

Spouse in the Practice

The non-dentist spouse can greatly influence practice operations, affecting the activities of the dentist(s), the operations of the practice, and non-dentist staff members. The relationships among

the incoming dentist, the incoming dentist's spouse, the practice owner, and the practice owner's spouse are crucial, especially if the practice owner's spouse is the office manager or otherwise works in the practice. A practice owner's spouse working in the practice is a very common occurrence, yet the dialog between the dentists often excludes the role of the spouse working in the practice.

Length of Association

How long should the association last? Some associates will work on a part- or full-time basis indefinitely and do not wish to own a practice. Others do desire to make their presence in the practice permanent as owners. For a specialist, the association typically lasts between 1 and 2 years. For general dentists, the association typically lasts 2 to 3 years, with exceptions. First, the associate and practice owner must want to practice together on a permanent basis. Further, the associate's productivity must be consistently sufficient to both earn an appropriate living for the period when the practice or practice interest is being paid for and meet the financial obligations of paying for the practice or practice interest. Therefore, the date of admitting the associate to ownership status should be based on performance and not time.

Associate Compensation

Associate compensation can and should be determined in advance of the hiring process through an analysis of what the practice can afford to pay with the owner(s) making a 10%-plus administrative profit, in light of market conditions whereby quality candidates may be difficult to locate. Market conditions currently provide for relatively high compensation to both general dentists and specialists. Why? There is currently a shortage of incoming dentists, particularly specialty practitioners in certain geographic areas. Added to this is the ever-increasing number of corporate practices that are recruiting dentists.

For example, let's say that the incoming dentist is overpaid. Assume that the practice owner earns 40% of gross revenues as owner compensation in all forms and agrees to pay the associate 35% of production, less 35% of the corresponding laboratory costs. The associate further receives credit for hygiene examinations but not hygiene services performed by the practice's hygienist(s). Assume further that the practice pays the associate's malpractice insurance, one-half of individual health insurance premiums, and $1,000 toward the cost of continuing education for each consecutive 12 months of the associateship. This seems like a fairly good compensation package for the associate. But how does the associate become an owner? The associate will not want to incur or accept a reduction in pay to become an owner, and there is not a sufficient difference between owner compensation in all forms and the associate's compensation to allow for future ownership. In addition, the practice owner earns little, if any, administrative profit during the term of the associateship. What if the associate earns 30% of production? Then the practice owner earns an administrative profit on the associate, and sufficient profit is available to allow the associate to be elevated to ownership, pay for the ownership interest, and not incur a reduction in pay. This assumes that the ownership interest is paid for within an agreed-upon and measured period of time, not to exceed 7 years. One way to resolve this compensation problem is to pay the associate the greater of a specified base salary, not a draw, per month or the agreed percentage of "adjusted" production or collections. Adjusted production is the associate's production, less write-offs, insurance and other refunds, uncollectible accounts, and/or laboratory remakes. Once predetermined production levels are consistently reached, the base salary becomes irrelevant; it should only be paid for a limited period of time, e.g., between 90 and 180 days.

There is also a shortage of new dentists who choose to work full-time and own practices, which means that the pool of associate dentists who will want to acquire your practice, in part or in whole, is shrinking. This may result in declining practice values and relatively high associate compensation in both general and specialty practices, not to mention tremendous difficulty recruiting new dentists in rural and undesirable geographic areas. Meanwhile, the corporate practices are doing a good job in recruiting and offering to pay school debt subject to the associate remaining employed by the corporate practice for a stated period of time.

It is important to complete an analysis of what the particular practice can afford to pay, given anticipated associate revenues, the administrative profit, overhead costs with the associate in place, including the variable expenses of additional laboratory and supply costs, additional equipment, and/or a chairside assistant. In short, what the practice can afford to pay an associate needs to be within its operational budget. It usually can and the associate's future ownership in a general practice is typically attributable to hygiene production, now allocated to the new owner. If the practice cannot afford the market rate for an associate, the practice owner needs to reorganize management systems in order to maximize profitability. Further, the practice owner should review the fees and the methods of patient payment. This is becoming more and more difficult with reduced-fee competition. After the practice becomes economically healthy, then the associate can be hired at a compensation package that the practice can afford to pay. The practice owner should not be fooled into thinking that a highly paid associate whothe owner takes time to train and mentor will pay a fair value for all or a portion of the practice in the future. Therefore, it is not enough just to hire the associate; the practice owner should authorize his or her advisors to complete the succession planning process, including the practice valuation and the terms, business, and tax structure of the future relationship with the associate. The potential associate should expect no less of the practice owner.

What is an appropriate rate of compensation? For a general dentist, it ranges from 25% to 35% of adjusted production or collections with the average at 30%. Another way to pay the associate is 25% of adjusted production, inclusive of all hygiene services. For a specialist, 35% to 45% of adjusted production or collections may be an appropriate percentage and a base compensation level for certain specialties.

If the practice owner and associate agree to a "draw" against future collections, the parties, particularly the associate, should agree to a provision contained in the employment agreement that the associate does not have to repay the draw should the associate leave the practice. Similarly, if the associate is paid on collections, the employment agreement should contain a provision that collections would continue to be paid for some period of time after the employment term ends and should also provide for an "accounting" of those collections.

For specialty practices, the recruitment process is clearly regional, if not national. Associate compensation packages for specialists in all cases, except prosthodontics, are high, but high associate productivity is also anticipated. The compensation is often increased each year incrementally during the associate period. There may also be a discretionary or productivity-based bonus provision.

Compensation, bonuses, benefits, and payment of business expenses should be specifically defined in the associate employment agreement. For example, in a general practice, the methodology for payment of laboratory expenses can be handled as indicated in Figure 9-1, A through D. Each method generates a different result. Further, it may be helpful to include any laboratory expense calculation, as well as any bonus provision calculation, as examples in a schedule to the employment agreement.

In certain circumstances it may be appropriate to reduce the associate compensation by any expenses and benefits paid on behalf of the associate. This ensures that the percentage of productivity or collections remains at a quantified rate.

Bonuses are designed to economically reward work over and above the standards expected by the employer. In dental practices, bonuses usually take the form of a reward for exceeding a predetermined level of collection or productivity.

Designing a bonus formula based only on collections or productivity is one dimensional. Consider designing associate bonuses to encourage quality of work, effort, attitude, and overall performance, yet while considering the cash and financial position of the practice. In short, bonuses should be discretionary for associates. The associate should benefit from a formula in which other important criteria in addition to productivity, e.g., quality of services, are evaluated.

Because the associate period is a time of mutual evaluation for both parties, the associate can assess the fairness of the practice owner, who often is more generous than necessary. If you are the associate and you don't like the bonuses or don't think that the practice owner is being fair, you should leave. Practice owners should evaluate much more than productivity, and inadequate performance can take many forms. Therefore, if more than production or collections will be evaluated, design an evaluation form to work from in light of the cash flow and financial position of the practice.

Proposal for Employment

Prior to the preparation of the associate employment agreement, the key terms of the employment relationship can and should be set forth in a "Proposal for Employment" letter.

Associate Needs Analysis

Does the practice need and can it support an associate? If so, what is the percentage of yearly practice collections available for the associate as compensation? Can the facility support the associate and allow multiple dentists to work comfortably and effectively?

An "Associate Needs Analysis" should be completed by the practice owner and advisor(s), most notably the practice's CPA prior to the interview. Figure 9-2 is an example of such an analysis. The Associate Needs Analysis provides that if the associate can cover all variable costs and contributes to fixed costs, the associate should be hired.

Assuming that the incoming dentist has completed the Qualitative and Quantitative Considerations and the practice owner has directed his or her CPA to complete the Associate Needs Analysis to determine and/or confirm that an associate should be hired, each party is ready for the interview.

Associate Interview Questions

The Associate Interview Questions, Figure 9-3, are applicable to both the incoming dentist and practice owner. While the Qualitative Considerations provide insight for the parties relative to what the incoming dentist wants in his or her career, the Associate Interview Questions provide guidance for a productive interview. Too often, interviews are based on whether "we like each other." Compatibility and comfort level are important; however, the 20 categories of interview

questions show that there are additional important considerations that need to be discussed by the practice owner and incoming dentist. In short, the incoming dentist needs to answer what he or she wants in a practice. The practice owner, on the other hand, needs to know whether the practice can support an associate. The 20 categories of interview questions are designed to assist the dentists in developing a positive long-term working relationship. Quality long-term working relationships are not often attained by accident. They are designed. By asking the appropriate questions of each other after you have completed your initial homework, you will minimize the risk of a failed relationship.

The Release Provision

As part of the interview process, the practice owner should request that the incoming dentist sign a written release as part of the written employment application. The release authorizes the practice owner to check the incoming dentist's references, both personal and professional. If the incoming dentist has not yet practiced dentistry or his or her specialty, the professional reference check would include discussions with professors. Further, the incoming dentist should be requested to provide written letters of recommendation to the practice owner. Such letters of recommendation may be from professional or personal references. The incoming dentist should also ask the practice owner for references prior to making the decision to join a particular practice.

Succession Plan

Unless a practice owner is planning to hire a permanent associate, the practice owner's succession plan should also be specifically defined prior to interviewing and hiring the associate. This means that the practice valuation and legal documents should be prepared in advance of the associate joining the practice. Why? Because determining practice value and preparing legal documents in advance generally reduces the risk of misunderstandings. While there are significant efforts and costs involved in defining the succession plan, preparing the practice valuation, and drafting legal documents, the succession plan will be in place, irrespective of the identity of the candidate/dentist who is intended to succeed the owner(s).

The succession exit options available to the practice owner are to sell the entire practice; hire the associate with the obligation to sell and to purchase the practice in 1 to 3 years; enter into a solo group arrangement whereby the associate acquires the goodwill attributable to the associate's developing patient base after 2 to 3 years, plus an undivided interest in the dental equipment, and where the practices thereafter operate separately under an office-sharing arrangement; enter into a co-ownership relationship, assuming that the practice owner intends to work for at least 5 more years on a full-time basis; or close the door and walk away after working for 1 or 2 more years.

If the practice owner chooses to sell the complete practice or close the door and walk away, the associate won't be hired. Similarly, if the associate will be a permanent full- or part-time associate dentist, the incoming dentist has less need than in anticipating ownership to complete any due diligence or purchaser homework investigation.

If the incoming dentist will play any part in the practice owner's predetermined succession plan, he or she should sign a confidentiality letter. When the interview process has progressed to an advanced stage, the new dentist should commence and complete the due diligence investigation. Unfortunately, the failure to undertake and complete the due diligence investigation is a significant cause of many failed associate relationships. Think about how difficult it would be to elevate an associate to owner without the two parties having a thorough understanding of the succession

plan, purchase price (or date and formula for its determination), and legal documents that delineate the business and tax structure.

Key Employment Agreement Provisions

Associate employment agreements alter any at-will employment relationship with the practice, whereby an employee can be fired for any reason, with or without cause. Many states have modified the employment at-will doctrine, giving employees remedies for inappropriate employer conduct.

Associate dentist relationships modify any at-will employment relationship to the extent of the associate employment agreement. So why have an associate employment agreement? Primarily, to protect the practice from dilution of value because of competition by a former associate dentist and to ensure that all parties understand their contractual obligations.

Below are the significant associate employment agreement provisions. These provisions are identical for both general dentists and specialists, except that specialists generally earn more in compensation and benefits than do general dentists, and specialists are usually prohibited from soliciting both patients and referral sources. Additionally, specialists tend to become owners earlier than do general dentists.

Employment

The employment agreement should provide for the practice to offer employment and for the associate to accept the employment under the terms and conditions of the employment agreement.

The employment agreement should provide that the entire employment relationship is covered by the employment agreement itself and that in the event of a dispute, no other verbal or written evidence may be admitted to trial other than the terms of the employment agreement. This provision was a key factor in a case that was successfully litigated by one of my partners, Richard D. Panza, Esq., in *Wall v. Firelands Radiology, Inc*. [1995], 106 Ohio App.3d 313. This case involved a restrictive covenant provision, among other issues, whereby an associate physician was precluded from admitting evidence regarding the employment relationship that was not covered in the employment agreement itself.

The agreement needs to survive its term so that the restrictive covenants/nondisclosure provisions are in effect should the associate leave the practice.

The associate should promise that he or she is not currently a party to any prior employment agreements. In the event that the associate would be violating a restrictive covenant provision by joining the practice, the practice and/or the practice owner could arguably be liable to the other practice that the associate left for intentional interference with the contract.

Employment Term

The employment agreement would commence on a certain date, provided that the associate is licensed to practice in that particular state. The employment term would continue until the earlier of a specified date or as provided in the employment termination provisions.

Employee's Compensation

The compensation section provides for and defines the payment of compensation and any bonuses. The obligation of the practice to pay the associate the compensation and any bonuses should be conditioned upon the associate adhering to the associate's duties and responsibilities, particularly the non-competition/non-disclosure provisions contained in the employment agreement.

There may be a signing or annual non-competition bonus, particularly if the employment term commenced prior to the associate signing the employment agreement. The signing or non-competition bonus provides for the associate's later promise not to compete as contracts need consideration on both sides. If the employment agreement is signed before the new dentist starts working, compensation and bonuses are the consideration for the non-competition/non-disclosure promises made.

Employee's Duties and Responsibilities

The duties and responsibilities section defines the associate's work schedule, full- or part-time, on-call time, and the authority and responsibility of the practice owner for the activities of the associate/dentist.

Employee's Non-Disclosure and Non-Competition Promises

The non-disclosure promises specifically define "confidential information" such as patient lists/referral source lists, practice forms, business and development plans, and computer information. The associate may not retain or disclose this information, which is owned by the practice, to any outside party during the term of the employment or for an agreed-upon period of time thereafter. The associate should be required to return any confidential information to the practice in the event that the employment terminates for any reason.

The non-competition promises provide that the associate may not compete with the practice within a specific geographic radius during the term of employment or for a specified period of time thereafter. Often a map is attached as an exhibit to the employment agreement that specifies the restricted area. Further, the associate may not, directly or indirectly, solicit patients and/or referral sources of the practice and may not hire employees of the practice for a specified period of time after the employment terminates for any reason. In those states where permitted, this section also grants a court authority to redefine the restrictive covenant provisions in the event that the court considers the restrictions too broad.

The incoming dentist may negotiate with the practice owner that the restrictive covenant not commence for some period of time, for example, 4 months. Additionally, if the associate is from the geographic area where the practice is located, the associate may negotiate a buy-out of the restrictive covenant based on the revenues generated by the associate, such as 37% of 1 year's gross revenues.

In the event that the associate grew up in the geographic area where the practice is located, a provision can be added whereby those patients directly referred to the practice by the associate are excluded from the restrictive covenant. The list is either handwritten or computer generated and continually updated. However, if a patient of the practice treated by the associate refers another patient, that new patient is the practice's patient and not the associate's patient. Upon

termination of the employment term for any reason, the associate is permitted to retain the charts and records of his or her patients.

Vacation and Other Time Off

The vacation and other time-off provisions provide for vacation time off, with or without compensation, for each consecutive calendar year or 12 months of the employment term. The time off may also be non-cumulative and forfeited if not taken within the applicable 12-month period. Further, the time off may not interfere with the time off anticipated by the practice owner, subject to a specified advance notice provision.

Educational time off may be granted by the employer, with or without compensation, for the associate's attendance at meetings, conventions, seminars, and/or post-graduate courses reasonably related to the associate's duties and obligations under the employment agreement, provided that the time off is approved, in advance, by the practice.

Other time off, paid or unpaid, may be granted. Other time-off would include military reserve duty, pregnancy leave, time to study for board certifications, moving or relocation time, specified holidays, emergencies, illness or sick days, jury duty, or sabbatical time. As much advance notice as possible should be provided for scheduling purposes for all time off.

Direct Business Expenses, Benefits, and Insurance

The direct business expenses, benefits, and insurance provisions provide for such costs, either paid for by the practice or by the associate during each consecutive 12-month period or calendar year of the employment term. In certain circumstances, the associate's compensation may be reduced by some portion or all of the costs, provided that federal tax laws are complied with.

Prohibition against Transfer

Prohibition against transfer provides that the associate cannot assign the associate's duties and responsibilities under the employment agreement to another. Without these provisions, the associate could arguably assign the associate's non-disclosure/non-competition promises to another.

Termination of Employment

Termination by notice allows either the practice or associate to terminate the employment relationship either without notice or with advance notice, e.g. 30, 60, or 90 days. However, if the practice terminates the employment term and does not want the associate to continue to render professional services, the employment agreement will provide that the associate will not be permitted to continue work, subject to patient abandonment concerns, and will be paid at a predetermined rate with benefits during any notice period. I prefer little, if any, notice provisions. If the associate does not want to work in the practice, he or she should leave. If the practice owner terminates the relationship, he or she would not want to pay the associate during the notice period. The associate would not want a lengthy notice period should he or she want to leave; however, many corporate practices require one. If there is a notice period and if the associate is compensated as a percentage of production or collections, the notice period compensation may equal the average monthly compensation for the 3 succeeding months prior to the month of termination of employment. This compensation, and any benefits, for the notice period should be specifically defined in the employment agreement.

In the event of the associate's death, the employment term terminates. If the associate incurs a disability, the practice owner should retain the option to terminate the employment term. Disability should be specifically defined in the employment agreement.

Breach of the contract by the associate-employee is a "for-cause" termination and should grant the practice the option to immediately terminate the employment term without notice. Such a provision may read as follows: "Notwithstanding any other provision of this Agreement, Employer may immediately terminate the Employment Term at any time and without prior demand or notice if: (a) Employee fails to perform, for any reason, any of Employee's obligations, duties, promises, or representations in Section __, (the non-disclosure/non-competition provisions); or (b) Employee commits a crime against Employer, or any of the Officers, Directors, employees, patients, or agents of Employer; or (c) Employee commits any other crime, except a minor traffic violation, or any act involving fraud, dishonesty, or moral turpitude; or (d) Employee fails to follow any employment directive or policy issued by Corporation." The point here is, for-cause termination should be defined and negotiated by the parties to the employment agreement being signed. Item (d), for example, may include a "cure" period.

In the event that the practice breaches its promises, such as not paying the associate, the associate should also have the ability to terminate the employment term without notice.

The practice would also retain the ability to terminate the employment term without notice if the associate is suspended from practicing dentistry or the associate's specialty or otherwise becomes disqualified to practice dentistry or the associate's specialty in a particular state. This provision may provide that the suspension or disqualification lasts longer than a certain period of time, such as 30 days.

Finally, the practice may retain a discretionary termination option that would terminate the employment term without prior demand or notice in the sole discretion of the practice. Such a provision is typically in effect indefinitely or for the first 90 to 180 days of the employment term.

Indemnification

In the associate's employment agreement, an indemnification provision means that either party should indemnify and hold harmless (protect) the other for its, his, or her actions.

Miscellaneous

This section provides for the application of the laws of a particular state in the event of a dispute and provides the place where the dispute will be decided.

Equity Purchase Provision

This section may be included to provide that upon a specified date or earlier if invited by the practice, the associate would have the option to acquire an interest in the practice, assuming that the associate remains employed at such time. This section may provide for defined performance and quality goals to be attained by the associate prior to the offer of ownership. The purchase price or appraisal prices, terms of payment, and structure of the transaction may be specifically set forth. Finally, the equity provisions where co-ownership is offered should be contingent upon the associate entering into a mutually agreeable (a) owner-employment agreement; (b) close corporation, shareholder, or operating agreement defining decision-making control or "founder's

rights" in the event of a voting deadlock or dispute; and (c) buy-sell agreement, providing for the obligation or option of the other owner(s) or practice to acquire the interest of the departing owner in the event of death, permanent disability, retirement, dispute, or other termination of employment. I prefer that the equity provision take the form of a freestanding option agreement with the corresponding agreements as schedules. Finally, a letter of understanding should precede the option agreement with corresponding agreements as schedules. The detailed letter of understanding outlines the key provisions of the contemplated ownership.

Additional Compensation and Continued Benefits

This optional section usually provides for the continued payment, if any, of compensation and coverage of benefits for some period of time in the event of death or permanent disability of the associate, typically until the disability income replacement insurance is in effect. At times, there may be continued payment of compensation in the event of temporary disability. These payments are typically offset by any disability income replacement benefit under the associate's disability insurance policy. In certain circumstances, there may be a period of severance pay that is often conditioned upon certain events, e.g., the departing specialist who is practicing in a particular state not competing with the practice within defined limits.

Anticipating Ownership

When is ownership discussed? The earlier the better. To the extent that the parties discuss and determine the fair market value of the practice and the date it is recalculated, the interest being acquired — a complete or partial interest in the practice, the payment terms, the structure of the transaction, the future obligation or option to buy out any existing owner(s)—the less chance there is for future misunderstanding on these complex matters. This process should be weighed against the economic cost of proceeding earlier, rather than at a later predetermined date, after the associate relationship has commenced.

Worker Classification

Worker classification continues to be an ongoing problem for associate and retired dentists or specialists as associates who continue to render professional services post-retirement because the IRS, and now the Department of Labor (DOL), as well as the individual states, believe they are incurring a huge loss in revenue, and workers are being denied benefits from misclassification.[43] Three agencies are auditing, and three different tests determine worker classification.

A practice cannot afford to pay the associate well and also pay direct business expenses, insurances (including health insurance), and benefits (including retirement plan benefits). Therefore, the practice prefers to classify the associate as an independent contractor to eliminate payroll taxes and all benefits. The associate prefers to be classified as an independent contractor because the associate can fully offset all benefits against income and also receive a higher rate

[43] American Bar Association, Section of Taxation Meeting, "Worker Classification – What's New Is Old Again," January 29, 2016, Los Angeles, CA; Prescott WP. Worker classification - A continuing problem. *Dent Econ.* 2017; 107(10): 28,30,32-33.

[43] Prescott, William P, et. al. "Worker Classification Best Practices and Remedies for Error: Options for Professional Practices." *Prac. Tax. Law.*, Fall 2018, pp. 23-32.

of compensation than as an employee because the practice has eliminated payroll taxes and benefit costs. As a result, the practice owner and associate think that so long as the associate agrees to pay all applicable taxes, they can simply elect to treat the associate as an independent contractor.

I am often asked "if the associate, as an independent contractor, and practice pay all applicable taxes, no harm, no foul, right?" No. The IRS has stated that where worker misclassification is found, the penalty is steep. The practice would be assessed all unpaid federal taxes, FICA, FUTA, fines, and interest.[44] The associate would lose nearly all deductions for benefits, subject to the 2% of adjusted gross income limitation.[45]

Except for limited situations in which a specialist renders specialty services for a general practice, through a separate entity, all other associates are employees. In fact, the IRS has stated where a retiring dentist was an employee of his or her own practice entity, it follows that the retiring dentist is an employee of the purchasing dentist's or specialist's practice. The IRS further stated that it believes that it can win this argument.[46]

Buy-Sell Agreements

The practice owner may consider a buy-sell agreement for the associate in the event of death or permanent disability. In short, if the practice owner dies or becomes permanently disabled, the associate buys the practice. Insurance should be considered as a funding mechanism, subject to health, cost, and availability. In the event of a catastrophe, the practice owner and his or her family members won't have to negotiate the sale of the practice under adverse circumstances. From the associate's perspective, he or she should understand that the deceased or permanently disabled dentist's practice won't be sold to another.

In the event that the association is unsuccessful, the associate leaves and starts over. From the associate's perspective, confidence and time are lost. Both the practice owner and the associate have much to lose by the associateship not working. Therefore, it is in everyone's interest to do everything possible to ensure the long-term success of the working relationship.

Summary and Thoughts

For practice owners, think long and hard as to whether you need or want an associate and why. If the Associate Needs Analysis shows that the associate will cover all costs and contribute to fixed overhead that the practice will have with or without the associate, the economic decision allows for the practice owner to proceed. However, that does not mean that other criteria are unimportant. Associates require both administrative and mentorship time.

For associates, you need to know what you're getting into in light of other opportunities and your future, including your practice vision or dream. You need to know that the Associate Needs

[44] Office of Chief Counsel Meeting, IRS, "Worker Classification: Employee or Independent Contractor?" August 13, 2008, Atlanta, GA.

[45] Internal Revenue Code (IRC) Section 3509.

[46] American Bar Association, Section of Taxation, Meeting, September 24, 2010, Toronto, Canada.

Analysis provides that the practice can support you as well. Although you need to earn a living, pay expenses, and pay your school debt, you also should consider your future.

Figure 9-1

EFFECT OF DENTAL LABORATORY COSTS ON ASSOCIATE COMPENSATION

Figure 9-1A

Production, Less Percentage Lab, Times Percentage

1.	Monthly Associate Production:	$30,000
2.	Less, 1/3 Dental Laboratory Costs Attributable To Associate (10% x .33 = $3,000 x .33 = $1,000):	<$ 990>
3.	Subtotal:	$29,010
4.	Compensation Percentage:	x 33%
5.	Monthly Associate Compensation:	$ 9,573

Figure 9-1B

Production, Times Percentage, Less Percentage Lab

1.	Monthly Associate Production:	$30,000
2.	Compensation Percentage	x 33%
3.	Subtotal:	$ 9,900
4.	Less, 1/3 Dental Laboratory Costs:	<$ 990>
5.	Monthly Associate Compensation:	$ 8,910

Figure 9-1C

Production, Times Percentage

1.	Monthly Associate Production:	$30,000
2.	Compensation Percentage	x 30%
3.	Subtotal:	$ 9,900

Figure 9-1D

Production, Less 1/2 Lab, Times Higher Percentage

1.	Monthly Associate Production:	$30,000
2.	Less, 1/2 Dental Laboratory Costs:	<$ 1,500>
3.	Subtotal:	$28,500
4.	Compensation Percentage:	x 35%
5.	Monthly Associate Compensation:	$ 9,975

Figure 9-2

ASSOCIATE NEEDS ANALYSIS

A. Assumptions

1. Associate Will Work Full-Time — 32 Hours Per Week and Will Earn the Greater of $120,000 (Includes Payroll Taxes and Benefits) Per Year or 30% of Adjusted Production, Including Hygiene Exam Fees, But Not X-Rays or Hygiene Services.
2. Assistant Will Cost $35,000 Per Year, Inclusive of Compensation, Payroll Taxes, and Benefits.
3. Additional Equipment, Remodeling, Supply, and Laboratory Costs, Payable Over 7 Years, Inclusive of Interest of $10,000.
4. Marketing and Advertising Costs of $10,000

B. Costs and Required Collections

1.	Associate	$ 120,000
2.	Assistant	$ 35,000
3.	Capital Expenditures, Supplies, and Lab:	$ 10,000
4.	Marketing and Advertising Costs	$ 10,000
5.	Estimated Yearly Associate Cost	$ 175,000
6.	Divided by 12 Months	÷ 12
7.	Minimum Monthly Collections before Administrative Profit	$ 14,583

C. Analysis

1. Practice Should Earn a 10% to 15% Administrative Profit On the Associate.
2. Mentorship Time, New Patient Flow, Facility Use, Practice Systems, and Reduction of Practice Owner's Collections Should Be Considered.
3. How Many Active Patients Are There in the Practice?
4. Why is the Associate Being Hired?
5. Note, $120,000 is 30% of $400,000.
6. **Business Rule — If Variable Costs are Covered and Associate Contributes to Fixed Costs, the Decision to Hire is Economically Sound.**

Figure 9-3

ASSOCIATE INTERVIEW QUESTIONS

1. Mission and Philosophy

What is the mission, philosophy, and clinical quality standards of the practice?

2. Goals

Do we share similar goals for clinical excellence, leadership, practice growth, and learning the business of dentistry?

3. Facility Design

How is the practice facility designed and what are the spatial limitations, if any? —Is the facility clean? —How many treatment rooms are there and how many hygienist(s) work in the practice? Who will work where as compared to current scheduling practices?

4. Compatibility

What type of person do I want to associate with and will patients and/or referral sources, as well as staff accept me? How do I give my patients away? Will we be compatible on both the professional and personal levels?

5. Personality Profiling

Will we use personality profiling testing to assess our compatibility? —If not, how will we evaluate each other? —At what point in the interview process will the non-dentist spouses meet?

6. Practice Systems

How are the practice's systems managed? A partial list of the systems that should be managed are described in Attachment 8.

7. Professional Services Performed/Collections

What procedures and services does the practice owner perform and what procedures are referred? What procedures and services will the incoming dentist perform? —How are the performed services paid for, and what is the collection policy and rate of the practice?

8. Work Schedule/Patient Assignment

What is the work schedule for the practice owner (days and hours)? What is the anticipated work schedule for the associate (days and hours), and how will patient assignments be made? —What kind of patients will be treated by the associate? —Inspect and discuss the appointment book! —Is the practice overbooked and do patients wait?

Figure 9-3

9. Internal and External Marketing

What is the internal and external marketing policy of the practice? What are the internal and external marketing expectations for the incoming dentist?

10. Coverage/On-Call

What are the office coverage on-call expectations for the incoming dentist and practice owner? How many emergencies occur on a monthly basis?

11. Mentoring

How will the clinical and administrative mentoring process take place?

12. Productivity

What are the productivity and revenue expectations for the incoming dentist?

13. Compensation

How will the incoming dentist's compensation package be structured?

14. Benefits and Expenses

What benefits and expenses will be paid through the practice versus the incoming dentist?

15. Staff Interview

At what point in the interview process will the staff be introduced to the incoming dentist?

16. Role of the Non-Dentist Spouse and Other Family Members

What is the role of the non-dentist spouse and other family members in the practice?

17. Restrictive Covenants/Termination of Employment

What are the restrictive covenants and termination of employment provisions in the event that the working arrangement fails?

18. Associate Employment Agreement

At what point of the interview process will the incoming dentist be presented with an associate employment agreement, and what are the terms? —Note, the incoming dentist is probably <u>not</u> an independent contractor.

19. Associate and Future Relationship

What is the length of the associate relationship, and what are the specific objectives for the future working relationship?

Figure 9-3

20. Purchaser Due Diligence–Succession Planning Documents or Proposal for Ownership

After signing a confidentiality letter, how will the incoming dentist evaluate the specific objectives for the future working relationship in light of cash flow and debt of the practice, practice valuation, and succession plan documents? See the Due Diligence Checklist in Figure 7-1. Certain of the items in Attachment 6 should be requested to be reviewed or used as part of the preparation or confirmation of the practice valuation.

Chapter 10

USING RESTRICTIVE COVENANTS

The primary value of any practice is its patient and/or referral base. In order to protect the patient and/or referral base, restrictive covenants are used as a tool to ensure that the parties to an associate employment relationship, sale and acquisition, associate buy-in, or owner buy-out live up to their promises.

Enforcement

Enforcement of restrictive covenants varies from state to state. Irrespective of enforcement, restrictions between owners where consideration is paid for a practice or practice interest is more likely to be upheld than is a restriction relative to an employment relationship. The rationale is that restrictions for employment of a dentist are inconsistent with public policy in allowing the public to receive professional treatment. This, however, depends on the particular state's statute and/or case law, the reasonableness of the restriction(s), the facts of the case, and the damage, if any, sustained by the practice.

Associate employment, sale and purchase, associate buy-in, and owner buy-out restrictive covenant provisions share common prohibitions as to time, geographic radius, non-disclosure of confidential information (e.g., patient lists and/or referral sources), and non-solicitation of patients, referral sources, or employees of the practice. Such restrictions may be in effect both during any employment term of the dentist and for some period of time thereafter.

Any agreement containing a restrictive covenant should include the transfer of the restrictions to successors and assigns.[47] This is particularly important if you sell your practice to a third party while an associate is working in it. Without the language that the agreement provisions go to successors and assigns, the associate may not have a valid restrictive covenant with the purchasing dentist. If you purchase a practice with an associate(s) working in it, have your attorney check to ensure that the restriction is applicable to your practice. Otherwise, an associate who already has patient and/or referral contact may be competing with you, maybe for a long period of time.

Associate Employment Relationships

Non-competition restrictions are most difficult to enforce because the associate has no equity in the practice and the relationship between the practice owner and associate is one of employer/employee. If the associate dentist is properly classified as an independent contractor, it may be arguably more difficult to enforce a restrictive covenant than if the dentist/worker is classified as an employee.

Arguably, it is important to have a signed associate employment agreement that contains restrictive covenants prior to commencing the employment. The reason is all contracts have consideration on both sides. In exchange for the associate's compensation, the associate promises to perform professional services and not to compete with the practice, solicit patients, referral sources, or employees, and not to retain or disclose confidential information. In the event

[47] *Ocordia of Ohio L.L.C. v. Fishel*, May 24, 2012.

that the employment begins and the associate is receiving compensation in exchange for services rendered, there is arguably no consideration for the associate's later promise not to compete after the employment term commences. If the associate started working without signing the employment agreement with the restrictive covenants, one way to resolve the problem is by providing a meaningful signing or annual non-competition bonus. This may provide consideration for the associate dentist's later promise to sign the restrictive covenant provisions. In the event that the associate may work at a second practice during the term of employment or if the employment is less than full-time, any ability to render professional services at another practice in or outside of the restricted area should be specified in the employment agreement. The agreement may merely specify that the employer may, should the practice choose, grant or consent to such other employment in writing. In a full-time position, all revenues generated by the associate may be considered property of the practice if specified in the employment agreement.

Another difficult, but interesting, restrictive covenant problem is where the practice desires to protect itself from competition and dilution of value in the event the associate relationship does not work out, yet the associate grew up or resides in the same community in which the practice is located. Protecting the practice versus the associate's ability to remain employed in the employee's hometown or place of residence are competing goals. Usually, balance can be found with compromise, effort, and all parties being reasonable. One way to effectively resolve this problem is to utilize a liquidated damage provision, whereby if the associate leaves the practice and works or sets up a practice within the restricted area, the associate would purchase his or her goodwill based on annualized production, e.g., 37% of one year's production. The liquidated damages provision would usually be a higher amount the longer the associate remains in the practice due to the associate's ability to attract patients and/or referral sources. This is one of the few instances where I recommend a liquidated damage provision. The provision would equal the goodwill produced by the associate.

Because courts typically look at the reasonableness of the restrictions to protect the legitimate interests of a business/practice, the court may consider the restrictions as overly broad. Certain states allow "blue penciling," whereby the agreement containing the restrictions may contain language that allows the court to reform the restrictions to what it considers reasonable rather than to not enforce the restrictions as all or nothing. Courts usually enforce contracts only within "the four corners of the contract" and do not permit the parties to the contract to present outside or parole evidence, except in certain instances. This is especially true if the contract contains an "integration" provision that states that the entire agreement is contained within the written contract. Therefore, if the state allows blue penciling, the employment agreement should provide specific language granting the court the power to reform the contract if the court determines the restrictions as overly broad.

Sometimes associate employment agreements contain liquidated damages as a deterrent to competition by the associate if the working relationship is unsuccessful. While a liquidated damage provision can relate to the value of the practice goodwill attributable to the associate, the court may not grant actual damages or an injunction, which would prohibit the associate from competing if the liquidated damage provision is present. Too often, employment agreements contain extraordinarily high liquidated damage provisions, which are used as deterrents. These amounts have no bearing on the reality of the working relationship with the associate. It's questionable whether an extremely high liquidated damage amount would even be upheld. However, I would not recommend paying an attorney to find out.

The bottom line is don't sign what you don't agree to. I routinely get calls from unhappy associate dentists who question whether the restrictive covenant provisions that they never meant to agree

to, but signed, would be upheld. Since the agreement is already signed, the associate must live with what was agreed to.

The associate agreement should provide that the associate is not bound by any other employment agreement, particularly one that prohibits non-competition. If you are the hiring dentist, particularly if you have actual knowledge of a prior agreement that restricts the associate from working in your practice, you and/or your practice could be liable to the other practice for intentional interference with a contract.

Finally, the associate should not be overly intimidated by agreeing to reasonable restrictions to adequately protect the employer/practice. Without agreeing to such a protection for the practice, the associate probably won't get the job and the practice owner will be reluctant to introduce patients and/or referral sources. Further, assuming that the associate relationship is successful, the practice owner will later be subject to similar restrictions in the event that the practice is acquired or the dentists become co-owners.

Sale and Acquisition

Another component of any practice sale and acquisition is the agreement by the selling dentist not to compete, in any entity, with the purchaser's newly acquired practice.

The time and geographic boundaries placed on the seller typically are more stringent than in associate employment agreements due to the purchaser's payment of consideration, the purchase price for the practice, time--5 years versus 2 years, and geographic radius, 15 to 20 miles versus 2 to 10 miles. With repayment periods increasing due to the success dental and other lenders have had with dentists and dental specialists, we are seeing 10-year repayment periods. Would you not want the seller bound by a restrictive covenant for 10 years? Unfortunately, I doubt that many state laws would uphold such a lengthy restriction. This is a question that is important for your advisors to look into when purchasing a practice.

The restrictive covenant should be drafted to restrict the selling dentist during the period of time such selling dentist renders professional services on behalf of the purchaser's practice. It should also run for the time period agreed to beginning on the date the selling dentist ceases to render services on behalf of the purchaser's practice. For example, one dentist worked for the purchasing dentist's practice for just over 5 years. The purchaser fired the selling dentist thinking that the restrictive covenant was in effect. In reality, the 5-year period commenced on the sale and acquisition's closing date, not on the date the seller's employment was terminated by the purchasing dentist's practice. The selling dentist, who remained in good health, bought a small practice a short distance from the purchaser's practice, hired former staff members, and ended up treating all the former patients whom he desired to treat. This situation was not intended by the purchasing dentist who had just relocated the acquired practice to an expensive new facility. The covenant period should have commenced when the selling dentist ceased to render services on behalf of the purchasing dentist's practice.

Many selling dentists do not want to sell their practices without maintaining the ability to continue to work on a limited schedule. While this factor may impact the determination of the purchase price and when it is paid, a phased-in retirement can greatly assist the purchasing dentist in retaining patients and seems to be a reasonable request. If, however, the selling dentist's employment is inappropriately terminated by the purchasing dentist's practice, a provision may be contained in the selling dentist's employment or independent contractor agreement, as the

case may be, that provides that upon inappropriate termination, the selling dentist's restrictive covenants would be null, void, and without effect.

In the event that the seller finances all or a portion of the selling price (hopefully not the case), the sale and acquisition documents should contain a "reverse covenant" whereby upon an uncured default by the purchasing dentist in the payment of the purchase price, such purchaser would be excluded from practicing dentistry in competition with the acquired practice according to the terms and conditions that the seller had agreed to not compete with the seller's former practice. In a purchase or default, the selling dentist's restrictive covenants would be null, void, and without effect. Of course, the selling dentist would also need access to patient records, the right to enter the practice facility, and the ability to take over the facility lease.

Associate Buy-Ins and Owner Buy-Outs

In group practice, all dentists in the practice typically are prohibited from competing. The rationale here is that a buy-sell agreement should be in place that would dispose of an owner's interest in the event of death, permanent disability, retirement, or termination of employment for any reason. In death, the departing dentist cannot compete. In permanent disability, the disabled dentist could compete if the disability would no longer exist, for example, hand problems that were resolved. Retirement, as a defined term, often triggers a mandatory buy-out, and the practice or purchasing dentist(s) would not want the retired dentist to compete. If a dentist elects to depart from practice and terminates employment, the other dentist(s) or practice may have the option to acquire the interest of the departing dentist. If the option is not exercised, the departing dentist would attempt to sell his or her interest to a third-party candidate, with authorization of the remaining dentist(s). In such a case, neither the third-party incoming dentist nor the other dentist(s) in the practice would want the departing dentist to compete.

Upon an owner's retirement, the retiring owner's interest would typically be purchased by the remaining dentist(s) through an obligation, as opposed to an option. In any buy-out, the remaining dentist(s) would not wish that the retiring owner(s) competes. Notwithstanding the necessity of strongly written restrictive covenant provisions, the remaining dentist(s) should consider making the retiring or departing dentist's payments for any practice interest contingent upon compliance with the non-competition provisions. Payments by the practice or remaining owner(s) to the retiring or departing dentist are usually paid over time. This is in contrast to cash in full at closing in a complete sale and acquisition of a solo practitioner.

Termination of employment for any reason, including dispute, may trigger a penalty buy-out provision, yet the restrictive covenants would remain in place for any buy-out of an owner.

Sometimes the dentist(s) owner(s) will agree to not practice together and will retain their respective patient and/or referral basis, split the tangible assets, and retain their own practices. In such cases, restrictive covenant provisions would not be in effect as no dentist is bought out.

There are several instances in which restrictive covenant provisions can be used to protect the practice. While usually applicable to associates and owners, it is advisable to restrict staff members from disseminating confidential information. The patient base is both valuable and confidential, and downloading confidential practice information is easier than ever today.

Summary

Restrictive covenants are important to protect and not dilute practice value. However, restrictive covenants should not be so onerous that a dentist who leaves an employment relationship or partnership must relocate in order to continue to practice his or her profession.

Chapter 11

PLANNING ASSOCIATE BUY-INS AND OWNER BUY-OUTS

Can co-ownership or partnerships work? Yes, assuming that defined criteria are met, some of which are described in Figure 11-1. Although partnerships can be more rewarding than solo practice for purposes of coverage, efficiency, and having another doctor(s) to work with, it is clearly more complex. This is because we need to deal with three categories—the buy-in, the buy-out, and operations. In addition to the three categories, there are three business and tax structures to choose, and two have tax problems under certain circumstances. Yet, partnerships are becoming more common than ever as practices continue to grow and expand. To operate profitably and control overhead, practice owners need associates who will stay permanently and later buy them out. In larger practices, this can best be accomplished through a partnership. As to the associate being elevated to partner status, the new partner needs assurances of earning a living with compensation greater than that earned as an associate after payment of the buy-in price. And is Dr. Junior willing to buy out Dr. Senior upon retirement? If not, do not enter into the partnership as it is Dr. Junior who is required to buy out Dr. Senior and locate a third dentist to join the practice. It is essential that practice revenue does not decline after Dr. Senior's departure, which is a major challenge. Want to continue? Read on.

As a former dental equipment specialist, dental supply representative, and general manager for 16½ years, I remember the dental groups of the mid-1970s that did not survive into the 1980s. Partnerships fail now for the same reasons they failed then. Some of these reasons are described in Figure 11-2. If problems from the past can be avoided, then a partnership may be recommended.

Review Your Succession and Entry Options Again!

Your exit and entry practice options are a complete sale, hiring an associate with a later and complete sale, a partnership, a solo group arrangement, or walking away. And for new dentists or specialists, establishing a practice is an additional choice. Prior to the senior and junior dentists entering into a partnership, both should examine all options with their spouses, if married, and their advisors regarding what they want in life, their vision or dream, and how long and how many days/hours per week they choose to work. A review of the succession and entry options is important because after the analysis, they may decide against partnership as their practice choice.

If the practice is or will be in a partnership, the junior dentist should agree to be obligated to buy out the senior dentist on the earlier of death, disability, or election to retire on or after a specified date. However, with no obligation for a buy-out, once the junior dentist has reached full capacity, there is no need to buy out the senior dentist, and the senior dentist's interest becomes almost worthless. It would be very difficult for Dr. Senior to find a third dentist to work with Dr. Junior and buy out Dr. Senior. While Dr. Senior and Dr. Junior may agree on Dr. 3, if the third dentist does not work out, the buy-out obligation should remain with Dr. Junior.

If Dr. Senior practices with another dentist roughly the same age, it is likely that there will be no mandatory buy-outs, except maybe for death or disability. Understand well in advance that continuous increases in revenue will be required to ultimately hire, train, and mentor two or more replacement associates who wish to practice with each other. As an alternative, consider dissolving the partnership and forming a solo group. A solo group of separate practices can allow

each owner to hire an associate and sell each practice upon departure, which probably will be at different times. Thereafter, each new practice owner would be a party to the solo group arrangement. The key in a solo group is to maintain separate patients; however, this does not work well in many specialty practices but can in some, such as in an endodontic practice. Also recognize that one owner in a two-practice facility will obtain a new telephone number. Generally, the solo group member who retains the existing telephone number pays for it.

The greater the number of years that Dr. Senior has to plan for retirement, the better. For partnerships, I suggest a minimum of 10 years. If the senior dentist plans to work 7 years or less, he or she should not enter into co-ownership because there isn't sufficient time for Dr. Junior to pay for the first half of the practice before the senior dentist leaves. In this case, dDr. Senior should pay Dr. Junior well for 3 years, then sell him or her the assets of the practice and goodwill in a complete sale. The purchase price (except for related parties where the practice was formed before August 10, 1993) will be all deductible to the purchasing dentist and mostly capital gains to Dr. Senior. From then on, the senior dentist works for the junior dentist, who owns 100% of the practice after 3 years, and the senior dentist remains employed under the terms of a post-sale employment agreement.

Joining the Practice

Unless the hiring of a permanent associate is contemplated, Dr. Senior should ensure that the written succession/exit plan is in place, the valuation is completed (in light of any necessary expansion or relocation), the tax and business structure is specifically defined, and the partnership agreements are prepared prior to Dr. Junior commencing employment under a written employment agreement. When done, the partnership usually works well, assuming that the associate period proves successful. If not, a failed associateship should not change Dr. Senior's succession plan and a new candidate should be considered. If it does, Dr. Senior has the wrong succession plan.

Dr. Junior's advisors should review the completed succession plan prepared by Dr. Senior's experienced dental attorney. If the experienced dental attorney is not admitted to practice in the Dr. Senior's state, local counsel should also be engaged on the advisory team. Before any confidential information is released to Dr. Junior, he or she should sign a written confidentiality letter.

Because of the complexity of partnership, in addition to preparation of the associate employment agreement, Dr. Senior's attorney should prepare a detailed letter of understanding of the key terms of the associate buy-in, allocation of compensation, decision-making control, employment of family members, and buy-out of an owner for any reason under the selected business and tax structure.

After the succession plan is completed, the next step is for Dr. Senior to complete the interview process of qualified candidate(s). This may include the use of personality profiling and testing tools. The reality, though, is that neither dentist knows how the other will perform, which is a major reason associate employment precedes ownership. The candidate's background and references should then be investigated under a written release. Dr. Junior should investigate Dr. Junior's background as well. Upon accepting a written employment proposal, Dr. Junior signs a written employment agreement that includes restrictive covenants, compensation and discretionary bonuses, payment of direct business expenses, benefits and insurances, work schedule, on-call responsibilities, vacations and other time off, and termination of employment.

Five additional comments on associate employment are worth noting. First, associate bonuses generally should not be productivity based; they should be discretionary, designed to measure Dr. Junior's total contribution to the practice regarding its cash and financial position. Measuring productivity only completely misses quality of work, effort, working relationships with staff members, patient responsibility, and efforts to further develop the practice, among other things. A discretionary bonus forces Dr. Senior to communicate with Dr. Junior so they can rate each other on a multitude of factors, inclusive of productivity, and justify the outcome.

Second, given the profitability of Dr. Senior's practice in light of the market for or availability of quality candidates, the practice must earn an administrative profit on the associate. An overpaid associate is a disaster to future ownership. If the senior dentist does not earn an administrative profit of roughly 10% to 15% from Dr. Junior, there will be insufficient profitability to admit him or her as a future owner. Because Dr. Junior will not want to take reduced compensation as an owner, the only available revenue to pay for the future ownership is hygiene profit in a general practice and the difference between owner compensation in all forms and associate compensation. This is why practice profitability is so important to future associate ownership.

Third, practice management consultants can be instrumental and extremely helpful in systems development, staff training, computer integration, goal setting, fee determination, coding, insurance documentation, revenue enhancement, and many other factors. With the assistance of the management consultant, each owner should take the initiative to become a leader of and learn how to manage the practice. Like any other business expenditure, the engagement of the management consultant should provide the practice with a return on investment. An improved bottom line assists in allowing Dr. Junior to grow into ownership.

Fourth, Dr. Junior does not begin work until the associate employment agreement is signed. Failure to sign the employment agreement could, in certain situations, render any later agreed-upon non-competition/non-disclosure provisions null and void unless consideration, in the form of compensation or a bonus, is paid for the later promise not to compete.

Finally, Dr. Senior should always look for an additional practice to purchase near the current practice location. An additional practice can assist in allowing Dr. Junior to increase collections sufficient to become an owner.

The Dr. Senior's practice in a partnership is identical to the valuation in a complete sale, except that Dr. Junior acquires a proportionate interest in the practice. For example, if Dr. Junior produces 50% of the doctor revenue, Dr. Junior would acquire a 50% interest in Dr. Senior's practice. If Dr. Junior produces 25% or 33⅓% of the practice revenue, Dr. Junior would purchase a 25% or 33⅓% interest. The interest purchased by Dr. Junior should match his or her percentage of practice productivity. This allows him or her to pay for the practice interest and not reduce compensation below the associate level, assuming that the practice is properly valued and Dr. Junior is not overpaid. And yes, this allows Dr. Junior to be elevated to ownership without collecting 50% of the doctor revenue. As productivity increases, the junior dentist's percentage of ownership also may increase.

The Three Business and Tax Structures

The three business and tax structures for associate buy-ins and owner buy-outs include stock including goodwill, stock excluding goodwill, and the three-entity method. There are tax risks with two of the business and tax structures, and it is important that both Dr Senior and Dr. Juniorand all advisors understand the risks, all of which are avoidable. If anyone thinks that the risks are

unimportant, your other partner, the IRS, does not think they are. In addition, the three categories of co-ownership (the buy-in, the buy-out, and operations) need to be considered when the partnership is contemplated. Dealing with these complex issues a year or two after an associateship begins will likely lead to disagreements over the purchase price, valuation date, and the business and tax structure.

Stock Including Goodwill

The purchase and sale of stock inclusive of goodwill in an S- or C-corporation is the only business and task structure without risk. Unfortunately, it is also the one used the least.

Under this structure, Dr. Junior pays income tax on all compensation earned and then pays for the stock in after-tax or non-deductible dollars. For Dr. Senior, all proceeds are taxed at higher tax rates as favorable capital gains as opposed to ordinary income. Therefore, all taxes are accounted for and both dentists, and the practice are free from IRS scrutiny in the event of an audit.

This business and tax structure only works from an economic standpoint where the tax-neutral fair market value of the practice is adjusted downward to account for Dr. Junior paying for stock without being able to deduct the purchase price in light of Dr. Senior receiving all capital gains. The downward adjustment applies to both the buy-in price and buy-out formula. However, when Dr. Junior sells his or her stock in the future, he or she only pays capital gains above the purchase price paid, or the "basis," for both the buy-in and the buy-out.

Stock Excluding Goodwill

Compensation Shift for the Buy-In

The purchase and sale of stock for the buy-in to a professional corporation excluding goodwill (calculated at the fair market value of the professional corporation's tangible assets or some predetermined value, e.g., $50,000 for 50% of the stock) is coupled with a compensation shift to Dr. Senior, which represents a pro rata percentage of the practice's or the senior dentist's goodwill, e.g., 50%. In exchange for selling a fractional interest in the goodwill, Dr. Senio receives additional compensation, often increased for the tax effect of receiving ordinary income instead of capital gains and again for an interest component, by providing administrative and management services to the practice under a practice management agreement.

Compensation Shift for a Buy-In to a C-Corporation

A tax case[48] reinforces the IRS' previous findings that advisors seemingly have forgotten — that if the C-corporation shareholders receive profits not generated by their own professional or other services, those profits can be recharacterized as unreasonable compensation to the shareholders.[49]

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[48] *Brinks Gilson & Lione, A Professional Corporation v. Commissioner.* T.C. Memo. 2016-20.

[49] *Pediatric Surgical Associates, P.C. v. Commissioner*, T.C. Memo. 2001-81; *Mulcahy Pauritsch Salvador & Co. v. Commissioner,* 680 F.3d 867 (7th Cir. 2012), Aff'd D.C. Memo. 2011-74; Elements common to the cases were that no meaningful dividends were paid and that all were accessed a 20% accuracy related penalty.

C-corporations are taxed at a 35% corporate rate and again at a rate of 20%, or double taxed. Compensation shifts are a problem for those practices operating as C-corporations because Dr. Senior may be receiving profits generated by Dr. Junior, and what might appear to be a tax-deductible compensation shift may be recharacterized as unreasonable compensation, resulting in non-deductible dividend treatment.

If stock excluding goodwill is to be used for a C-corporation or an S-corporation that was a C-corporation within the previous 10 years, consider the following: convert to an S-corporation, pay a meaningful dividend, authorize preparation of a services agreement with the corporation, maintain an administrative and management log, and prepare Directors' Minutes each year. Compensation shifts can be workable if proper precautions are taken. However, thought should be given to ensure that the management compensation shifted equates to the management services rendered by Dr. Senior. One concern should be that if the sum of the compensation shift is directly tied to the goodwill piece of the appraisal, the direct tie-in could make it difficult to prove that the management fees equate to the management services provided.

Personal Goodwill for the Buy-In

Rather than utilize a compensation shift, some advisors are advocating Dr. Junior's purchase of personal goodwill for the buy-in. However, personal goodwill is not deductible to an individual who is not a "trade or business."[50] Remember that any use of personal goodwill requires an appraisal.[51]

Deferred Compensation

Sometimes buy-outs are structured with stock being purchased by the professional corporation, excluding goodwill, coupled with the payment over time of deferred or continued compensation to Dr. Senior by the practice for the departing shareholder,[52] which represents the remaining goodwill in the practice (e.g., 50% if 50% was previously purchased with Dr. Junior being a 50% shareholder). While payments for deferred compensation are deductible to the practice, they are taxable as ordinary income to Dr. Senior or the departing shareholder. Just as in the compensation shift, the deferred compensation formula includes a gross-up component for ordinary income versus capital gains and an interest component.

Unfortunately, there is little security for payment of deferred compensation because it is an unfunded obligation of the practice. Therefore, it works best for family members rather than third parties. Moreover, deferred compensation arrangements are now subject to the complexities of IRC Section 409A and its harsh penalties for non-compliance. The primary effects to the senior dentist are strict rules on the payment of accounts receivable, a specific formula for calculating the sum of the deferred compensation, the timing of the date of payments, and no ability to prepay the deferred compensation.

[50] IRC Reg. 1.212-1; *Harry R. Haury v. Commission*, T.C. Memo 2012-215; Code Sec(s) 72; 408; 166; 6651; 6654; 7491.

[51] *Kennedy v. Commissioner*, T.C. Memo. 2010-206, (*Kennedy*).

[52] Revenue Ruling 60-31.

Personal Goodwill for the Buy-Out

Another buy-out structure is where the departing shareholder's (assuming Dr. Senior) stock is purchased by the practice excluding goodwill, but is coupled with the purchase by the practice of the departing shareholder's personal goodwill. To the extent that there is personal goodwill,[53] the purchaser, which is the practice and not Dr. Junior, is able to amortize or deduct the personal goodwill over 15 years while the purchase of stock cannot be deducted. Advisors advocating this method are attempting to get the personal goodwill to be taxed at favorable capital gains at one tax level to Dr. Senior and not double taxed.

Understand, however, that the purchase and sale of personal goodwill is not without significant problems. First, if personal goodwill is part of the transaction, Dr. Senior cannot be, or have a written agreement that he or she will be, subject to a restrictive covenant with the practice upon the buy-out.[54] This point effectively eliminates this business and tax structure because Dr. Junior will/should require that Dr. Senior be subject to a restrictive covenant and vice-versa.

However, in both *Martin Ice Cream* and *Norwalk*, had the shareholders not have had covenants not to compete with the purchaser, there would not have been personal goodwill. Therefore, to use personal goodwill in a shareholder buy-out, the shareholder cannot be subject to a restrictive covenant or a written promise to not enter into a restrictive covenant with a practice; but if there is no restrictive covenant with the purchaser, there is no personal goodwill. As a result, the use of personal goodwill in a shareholder buy-out is inadvisable, at least in my view.

In addition, if the practice was formed prior to August 10, 1993, the goodwill is not deductible. Finally, if personal goodwill for a shareholder buy-out is used, it is important to have an appraisal that distinguishes your personal goodwill from any corporate goodwill.[55]

Three-Entity Method

An increasingly common business and tax structure for partnership is for Dr. Junior to form an S-corporation and purchase a fractional interest in the tangible assets and goodwill from the practice owner or the owner's practice entity.[56] After the purchase, the senior and junior dentists operate the practice through a newly formed limited liability company or partnership, a third entity, that collects the revenue, pays the operating expenses, including employee benefits, and employs the staff. Profits are distributed to the entities, which are owned by Dr. Senior and Dr. Junior and which pay the direct business expenses of each owner, e.g., Dr. Senior's S- or C-corporation and Dr. Junior's newly formed S-corporation. The three-entity method also may include use of a compensation shift, the purchase of the practice owner's personal goodwill if the practice operates as a C-corporation, questionable S-corporation distributions (because all distributions from limited

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[53] The following recent cases recognize the existence of personal goodwill: *Muskat v. U.S.*; 554 F.3d 183; *Solomon v. Commissioner*, T.C. Memo. 2008-102, 208 WL 1744406 (U.S. Tax Ct.).

[54] *Martin Ice Cream v. Commissioner*, 110 T.C. No. 189 (1998) (*Martin Ice Cream*); *Norwalk v. Commissioner*, T.C.N. 1998-279 (*Norwalk*); *Howard v. U.S.*, 2010 WL 3061626 (E.D. Wash., July 30 2010); *Howard v. U.S.*, United States Courts of Appeals for the 9th Circuit, No. 10-35768, D.C. 2:08-cv-00365-RMP, August 29, 2011.

[55] *Kennedy v. Commissioner*, T.C. Memo. 2010-206.

liability companies and partnerships are earned income), and/or independent contractor relationships. Note that the tangible assets may be owned by the respective corporations because the transfer of equipment to the limited liability company or partnership may create a taxable event. New purchases of equipment and technology, however, can be made by the third entity, the limited liability company, or the partnership.

The Anti-Churning Rules

If the practice was formed prior to August 10, 1993, the buy-in and buy-out under the three-entity method, as well as the purchase of any personal goodwill of the practice owner by the practice upon Dr. Senior's buy-out, is subject to the IRC Section 197 anti-churning rules. The anti-churning rules deny amortization of the goodwill purchased by Dr. Junior if Dr. Senior and Dr. Junior jointly did or will own 20% or more of the third entity[57] or are family members, e.g., Dr. Senior and his or her son or daughter/dentist, even in a complete sale to a family member. It is the third entity, the limited liability company or partnership that creates the problem for non-related owners because 20% or more common ownership makes the owners related parties. IRC Section 197 does not provide for separation of the pre- and post-August 10, 1993, goodwill.[58] While I have not seen any audits on this point yet, note that the IRS is well aware of this situation and has stated that it can track asset sales through Form 8594, which must be filed by Dr. Senior, his or her corporation, and Dr. Junior.[59] There is direct authority under the IRC Section 197 Regulations for the IRS to recast the transaction to avoid any of the anti-churning rules.[60] Notwithstanding, the IRC Section 197 Regulations do provide guidance to avoid the anti-churning rules in Example 19.[61] Here, Dr. Senior's S- or C-corporation contributes its tangible assets and Dr. Senior contributes his or her personal goodwill to a newly formed limited liability company in year 1. On the first tax return, the limited liability company makes what is called an IRC Section 754 Election. In year 2, Dr. Junior purchases 50% of Dr. Senior's membership interest in the limited liability company. However, Example 19 seems to conflict with the authority of the IRS to recast the transaction. As a result, I am not convinced that following Example 19 is a workable solution. In addition, we cannot readily locate dental appraisers to appraise personal versus corporate goodwill, as opposed to the goodwill of the entire practice. If Example 19 is utilized, an appraisal of the personal goodwill is essential.[62]

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[57] IRC Reg. 1.197-2(h)(6)(i)(A).

[58] Mergers, Acquisitions, and Buyouts, Martin D. Ginsburg, Jack S. Levin, Aspen Publications, 4-118, Example 17, Section 403.4.4; December, 2002; Example 20, Section 403.4.1.4, February 2012.

[59] American Bar Association, Section of Taxation, Meeting, Toronto, September 24, 2010, "Co-ownership – Taxing Decisions"; "Co-Ownership: a taxing relationship," *Dental Economics*, September 2010; "Co-Ownership – What Works, What Doesn't and Why!", *Dental Economics*, April 2015.

[60] IRC Reg. 1.197-2(j).

[61] IRC Reg. 1.197-2(k), Example 19.

[62] *Kennedy v. Commissioner*, T.C. Memo. 2010-206.

[62] IRC Section 197(f)(9)(A)(i); IRC Reg. 1.197-2(h)(2)(i).

[62] Altieri, Mark P. and William P. Prescott. "Professional Practice Transitions, Section 197, and the Anti-Churning Rules." *Prac. Tax. Law.*, Summer 2018, pp. 23–31.

If, on the other hand, Dr. Senior and Dr. Junior operate separate practices under a solo group arrangement with no common ownership of a third entity, the goodwill is amortizable for the buy-in and buy-out, except for family members. What's more, each separate practice may adopt its own tax-qualified retirement and health plans without covering the eligible employees of both practices. Shared employees, e.g., hygienists, are permitted under solo group arrangements. Notwithstanding the ability to amortize pre-August 10, 1993, goodwill, solo groups work well because Dr. Junior usually is not required to purchase Dr. Senior's practice upon retirement but may retain the option to do so. Because the practices are separate, the senior dentist can sell his or her practice to a third-party dentist if Dr. Junior does not exercise any option to purchase. Death or permanent disability, however, sometimes requires a mandatory purchase. Compensation allocations in a solo group tend to benefit Dr. Senior more than in co-ownership arrangements because each practice owner usually pays 50% of all common operating expenses.

Business and Tax Structure Summary

Remaining a solo practitioner is best, followed by practicing in a solo group as second best. If a practice owner is contemplating admitting Dr. Junior as a partner or the practice already operates as a partnership, any of the three business and tax structures can work if the tax risks are recognized and avoided. Advisors with experience in dental and dental specialty partnerships should be hired and tax risks should be expected to be disclosed. Ensure that counsel licensed in your state is on the advisory team.

Stock in After-Tax Dollars

If the practice was formed prior to August 10, 1993, my recommendation for partnership is the purchase and sale of stock in after-tax dollars and a downward adjustment to the purchase price and the buy-out formula for the tax benefit in light of the tax detriment. It is simple. There are no tax risks, and there is one entity.

Stock Excluding Goodwill

While a headache to calculate and keep track of, stock excluding goodwill, coupled with a compensation shift, is workable for the buy-in piece, but take precautions if the practice operates as a C-corporation. Stock excluding goodwill, coupled with Dr. Junior's personal purchase of Dr. Senior's personal goodwill is not deductible to Dr. Junior because he or she is not a trade or business. For the buy-out, stock excluding goodwill coupled with deferred compensation works well provided that the senior dentist understands that the payments will be made over time. Stock excluding goodwill coupled with the professional corporation's purchase of Dr. Senior's personal goodwill is not appropriate due to the restrictive covenant issues and the anti-churning rules if the practice was formed before August 10, 1993.

Three Entity Method

The three entity method does work well if the practice was formed after August 10, 1993, notwithstanding the complexity and increased accounting costs of operating three entities. If the practice was formed prior to August 10, 1993, understand that the goodwill sold is not amortizable or deductible to Dr. Junior for either his or her buy-in or Dr. Senior's buy-out. Carefully consider S-corporation dividends under the three entity method, consulting with your CPA. Finally, solo group arrangements provide a good alternative for general practices to allow for goodwill to be amortized or depreciated where it would otherwise not be.

Ask that your advisors keep your other partner, the IRS, in mind when developing the business and tax structure of any partnership for both the associate buy-ins and owner buy-outs.

The Economics of Associate Buy-Ins and Owner Buy-Outs

After determining the proper business and tax structure for the partnership, there are two points to consider. The first is whether the associate is ready for ownership and can pay for the buy-in without incurring a pay reduction. The second is to ensure that the buy-sell agreements consider all buy-out triggering events without an undue windfall for early termination by either Dr. Junior or Dr. Senior.

Associate Buy-Ins

Associate buy-ins should be based on performance standards measured over time. The performance standards are determined when the ownership process begins. The standards include not only productivity but quality of work, effort, professional relationships with patients, referral sources and staff, and overall contribution to the practice They are further based on the cash and financial position of the practice as part of the strategic planning process. Associate buy-ins for general practices average 2 to 3 years and 1 to 2 years for specialists. This is a relatively short time period as compared to legal and accounting firms.

Associate buy-ins should be internally financed because lenders will not lend on the sale of a partial interest unless the practice entity and/or practice owner guarantees Dr. Junior's loan, at least for some period of time. The problem is if Dr. Junior leaves and Dr. Senior has been paid for the buy-in in cash, the practice and/or Dr. Senioris a guarantor of the buy-in loan. That should make any senior dentist uncomfortable. Yes, in certain circumstances, we can get limitations on loan guarantees, and yes, the buy-sell agreement provides that Dr. Junior gets very little back, less any default sum, should he or she leave early, but there is no need to go through all that.

Some advisors still advocate that Dr. Junior's compensation as an associate be reduced and a portion of it held in escrow for a future buy-in. The reality is that there is insufficient profit attributable to Dr. Junior's collections or productivity to pay him or her at market rates and contribute any meaningful amount to an escrow account. Also note that the funds held in escrow are taxable as ordinary income to Dr. Junior each year.

The purchase price for the associate buy-in is based on an appraisal of the practice. Whatever valuation method is used for the associate buy-in, Dr. Junior must be paid fairly (more than he or she earned as an associate) to pay the lender(s) and to pay Dr. Junior's share of the operating expenses, all within a predetermined time period. I suggest not including an increase in the purchase price for accounts receivable or a reduction for debt, except in rare circumstances. But, if accounts receivable are included or increased, debt should be included or decreased on a pro rata basis. Dr. Junior'sCPA should confirm or refute the valuation report prepared by Dr. Senior's appraiser. While the senior and junior dentists may agree on the appraiser used, note that the appraiser was probably paid by Dr. Senior or the practice. A realistic valuation is crucial because if the economics are faulty, the partnership fails. It is also advisable that Dr. Senior's CPA confirms or refutes the appraisal.

The valuation report for the practice should be completed for the calendar or fiscal year immediately preceding the associate's employment. An updated valuation report should be prepared 1 year after Dr. Junior works in the practice on a full-time basis. The rationale behind a

valuation after 1 year of employment is that for at least the first year, and probably the second, Dr. Junior's production is from the pent-up practice demand and not his or her efforts. Dr. Junior should not accept a valuation report prepared for the calendar or fiscal year immediately preceding his or her ownership, depending on how far in the future the ownership is. An exception occurs when Dr. Junior is entering into a solo group or is able to purchase or become an owner of the primary practice location where he or she works with a predetermined purchase formula.

For those practices operating as S-corporations, distributions must be made on the basis of ownership. For the buy-in, Dr. Junior should purchase and pay for a pro rata percentage of stock each year until he or she completes a predetermined percentage, e.g., 50% or 49%. If, on the other hand, Dr. Junior purchases 50% or 49% of the S-corporation's stock under a 5- or 7-year promissory note, he or she is entitled to 50% or 49% of the S-corporation distributions without Dr. Senior having been paid for the full buy-in.

Owner Buy-Outs and Buy-Sell Agreements

It is essential that the buy-sell agreement is in place at the time the partnership is formed because any owner can leave the practice at any time for any reason. Triggering events include death, disability, dispute, termination of employment, or retirement (as a defined term [e.g., attaining a specified age and electing to retire, but not later than a specified age]). Retirement may also automatically occur if workdays and or owner collections fall below a specified level.

I believe that all triggering events should require mandatory buy-outs and should be payable in cash in a two-owner practice. The question is what the buy-out price is under each triggering event and whether there should be differences. One exception to a cash-in-full buy-out is the business and tax structure of stock excluding goodwill where the goodwill for a departing owner is payable over time through deferred or continued compensation. The other exception is where the owners are of similar age. In these situations, the only mandatory buy-out may be death or disability. The challenge is to locate a purchaser(s) to purchase a sizable practice. For this reason, I have reconstituted some similarly aged co-owners into solo groups or separate practices, allowing each owner to sell when ready while still practicing in the same facility.

For practices with more than two owners, Dr. Junior (or Dr. 2) does not want to be affected by a newly admitted owner's (or Dr. 3's) purchase of Dr. Senior's interest. An exception is when all remaining or surviving owners are required to buy out Dr. Senior, which is rare.

Term life insurance is advisable in the event of death, although it may not be available or affordable to all owners. If it is not, the uninsured owner is bought out under the same terms as retirement. Disability buy-out insurance is difficult to locate and costly to obtain. Disability buy-out insurance should not be confused with important disability income replacement or overhead insurance. Any use of insurance to fund life and any disability must be consistent with the buy-out business and tax structure.

Buy-sell agreements should be drafted in accordance with the business and tax structure for any associate buy-in(s) and future owner buy-out(s). In two-owner practices, the buy-out can be structured for a cash-in-full buy-out. Not the case for a more than two-owner practice unless the practice or all owners are purchasers. In such a case, the buy-sell agreement should provide that the buy-out would be seller financed and the remaining owner(s) would pay a fixed rate or percentage, e.g., 2%, above the prime rate charged by the practice entity's bank on the purchase date.

The purchase price for a buy-out should be determined in one of three ways—by formula, appraisal, or an agreed value. Like the buy-in, an increase for accounts receivable and decrease for debt should not be considered unless provided for in the buy-out formula(s).

The formula method provides for an increase or decrease in practice growth over time. If a partnership significantly increases in value, the formula provides for the departing or retiring owner to share one-half of the increased growth if 50% / 50% partners. If revenue declines, the formula calculates a decreased value. I favor the formula method because both/all owners contribute to the increases or decreases in growth. The formula calculation must be understandable and relatively easy to calculate. If the owners cannot understand the formula, how can they agree to it?

The appraisal method can work, but appraisal findings vary depending on the appraiser, they can take considerable time to prepare, not to mention that they can be costly. However, if an appraiser is designated by name and if the specific appraiser is unavailable, another appraiser must be agreed upon by the owners with a tie-breaking mechanism should they not agree. Another important point is that the appraisal methodology can be specifically identified for appraisal instructions and similar to a formula. Further, the buy-sell agreement should state that the most recent appraisal will control so that the owners are not without an appraisal, which can cause major disputes. Unfortunately, owners almost never update appraisals. We make any update an agenda item for the annual client meeting with the owners and CPA.

While agreed value is definite, it does not consider either practice growth or decline. Agreed value is often used when Dr. Senior plans to retire within a relatively short period of time, e.g., 3 years out. Sometimes the agreed value is increased by a pro rata percentage of the cost of additional mutually agreed tangible assets and technology, with an exception for equipment breakdowns where an equipment item must be replaced. Another exception is where the partnership entity purchases an additional practice, which will increase value.

The associate's overall performance must warrant the associate's elevation to ownership, the buy-in must be paid for within a measured period of time without the new owner incurring a pay reduction, and all buy-out triggering events must be included in the buy-sell agreement and ancillary agreements, e.g., deferred compensation agreements.

Operations

Retirement Plan Funding

Some consulting companies promote that Dr. Senior should design the practice's retirement plan as a defined benefit or cash balance plan linked to the anticipated profit from Dr. Junior's production. The problem is that these contributions are mandatory for at least 5 years and can be a problem to fund if the junior dentist leaves the practice and overhead costs increase. Here, Dr. Junior receives less compensation than the senior dentist for several years, with the excess compensation being contributed to the practice entity's retirement plan to primarily benefit Dr. Senior, although not at the expense of Dr. Junior or staff. Depending on the age and income of the doctor/owners and staff, the benefit can be very significant to Dr. Senior. Some of the points to consider before such a plan is adopted are listed in Figure 11-3. However, retirement plans can now be designed as favorable safe harbor 401(k) profit-sharing plans and may be "cross-tested" to consider age to provide additional benefits to the practice owner(s) with minimum contributions for eligible staff. We can easily get $55,000 plus to owners, and staff can save pre-tax in the plan within limits. Owners can also contribute for their spouses who render legitimate services for the

practice. Save consistently and early and the funds will substantially compound over time. The good thing is that except for a minimum 3% or matching up to 4%, contributions are not otherwise mandatory each year in a safe harbor 401(k) profit-sharing plan. If the practice must expand or relocate as a result of Dr. Junior joining, there may be an impact on the ability of the practice to make substantial retirement plan contributions at a particular point in time.

Allocation of Compensation

Compensation, bonuses, direct business expenses, benefits, and insurances are usually allocated in one of five ways: the respective collections or productivity of one owner as a percentage of the collections or productivity of all owners, and whereby general operating expenses may, or may not, be equally shared; pro rata ownership percentage; administrative and management responsibilities; and/or the number of days, half-days, or time spent working in the practice. Note that retirement plan contributions are based on total compensation by law and it is sometimes challenging for multiple owners to agree on the same plan design and funding level. However, retirement plan contributions can be designated through the compensation formula to accommodate all owners.

It is still common to allocate yearly or quarterly compensation as follows: the sum of the available compensation multiplied by a percentage, the numerator of which is the percentage of the respective owner's collections as a percentage of all owner's collections, and the denominator of which is the collections of all owners. Here, expenses are not equally allocated but paid by the practice. Monthly draws (usually paid every 2 weeks), direct business expenses, individual insurances, and individual benefit costs are subtracted from the yearly or quarterly profit distribution. This allocation is favorable to Dr. Junior who generally collects less than Dr. Senior. Note that in compensation allocations, hygiene and associate profit are included in the distributable profit to owners. For example, if Dr. Senior collects 60% of owner collections and Dr. Junior 40%, the senior dentist receives 60% of the profit and the junior dentist 40%. See Figure 11-4, Overhead Allocation Chart.

However, if operating expenses are allocated equally to owners on the basis of ownership and profits are distributed as a percentage of the collections of the respective owner as a percentage of the collections of all owners, the result is much different. The owner(s) with the lowest collections receive(s) much less pay than the owner(s) with the higher collections. In the Overhead Allocation Chart example, practice collections are $2,000,000, owner profit in all forms is 40%, Dr. Senior's collections are 60% of owner revenue, and Dr. Junior's are 40%. Where overhead is equally allocated, Dr. Senior now receives 75% of the owner profit and Dr. Junior 25%. As a result, the compensation allocation can significantly affect what Dr. Junior can afford to pay for his or her practice interest.

An alternative to an equal overhead allocation is to allocate 60% or some percentage of owner compensation on the basis of respective collections and 40% or some percentage to ownership. The compensation allocations include hygiene and associate profit and, in an S-corporation, may be distributed as dividends on the basis of ownership percentage as agreed by the practice's CPA. Either way, monthly or bi-weekly draws, direct business expenses, insurances, and benefit costs are subtracted from the yearly or quarterly profit allocation.

Irrespective of the compensation allocation utilized, an example should be attached as a schedule to the shareholder employment agreements or multi-member operating agreement with a copy to the practice's CPA, who should approve the compensation formula. Without the CPA's

involvement, profit may be distributed differently from what owners had agreed upon, resulting in an irreconcilable dispute.

Decision-Making Control

Decision-making control can be equally allocated among the owners or vested in one or more owner(s) under the particular state's close corporation or shareholder agreement statutes.[63] Approximately 16 states have such a statute in effect. In the states that currently do, the "founder" or Dr. Senior can avoid having to retain a 51% ownership interest in the practice for maintaining control or the use a separate class of stock for voting and non-voting interests. If the practice operates in a corporate format under such a statute, operational control or the "tie-breaking" vote can be vested in Dr. Senior so long as he or she owns at least one share of the professional corporation's stock. Voting control also can be allocated to the newer owners, usually by seniority. For those practices operating as a limited liability company or partnership, management control usually can be allocated through the operating agreement, depending on the particular state's limited liability company or partnership statutes.

Dr. Junior, however, would want to share equally in decision making or operational control of the practice. If not, Dr. Junior may propose to reduce the practice value to reflect a "lack of control" discount. From the junior dentist's perspective, any interest in the practice should be equal to Dr. Senior, e.g., 50% in a two-doctor practice. Otherwise, it can be argued that the relationship is not a true partnership and perhaps should not be entered into. However, it is probably not a good idea to think that way.

Almost all associate buy-ins are internally financed, as any lender would require the practice's or Dr. Senior's guaranty as security. Assuming that the associate buy-in is internally financed or the loan guaranteed by Dr. Senior, the senior dentist may retain decision-making control in the practice until the buy-in is fully paid. However, certain decisions should require the unanimous consent of all owners, such as the hiring of an additional dentist or specialist, expenditures over a threshold amount, relocation of the practice, and/or the acquisition of an additional practice. After the buy-in is fully paid, decision-making control is equal, assuming that dispute resolution devices are contained in the shareholder or operating agreements. An example of such a control mechanism would be a determination of who would remain in the practice location and who would relocate in the event of a dispute. Such a decision may depend on the ages of the owners. Sometimes a provision is included in the new owner's employment agreement whereby Dr. Senior can terminate Dr. Junior's employment by notice, but incur a 50% penalty in value (or 150% of the buy-sell agreement value) for doing so. Another option is for the practice to pay Dr. Junior a pro rata value of tangible assets and allow him or her to practice within the restrictive covenant area so long as Dr. Junior has fully paid for the buy-in. This device works very well where family-owned practices have admitted owners who are not family members. If the junior dentist quits prior to completing his or her buy-in and Dr. Senior's buy-out, Dr. Junior is similarly penalized—typically 50% of the value. There should never be a windfall to Dr. Junior for leaving early and not completing any obligation to buy out Dr. Senior.

[63] Statutory Close Corporations Permitted in Some States. http://www.bizfilings.com. Accessed February 16, 2017.

Dispute Resolution

Dispute resolution devices should always be in place in any partnership to resolve voting deadlocks. The buy-sell agreement, close corporation, or other shareholder or operating agreement for a limited liability company may contain one or multiple dispute resolution devices. Such devices may include a specified arbitrator, a "Russian-roulette" provision whereby one owner must buy out the other owner should one make an offer and the other not accept, or a corporate division under IRC Section 355, which would divide the professional corporation into separate practices tax-free if certain technical requirements are met.

For co-ownership to be successful, the shareholders, members, or partners should commit to holding regularly scheduled board, member, or partner meetings with a written agenda to discuss practice business. Further, a yearly meeting should be held with the practice's CPA and attorney and any other key advisors to review practice operations for the most recent calendar or fiscal year—primarily to plan for the next year, but also for the future 5 years in accordance with the practice's strategic plan.

Employment of Family Members

While Dr. Senior is the only owner, the employment of family member(s), e.g., his or her spouse, works well. However, in a partnership, employment of family member(s) as dentists and/or staff should always be discussed and agreed upon by all owners and any incoming new owner in advance. Where a spouse is employed by Dr. Senior's practice, such employment may be a condition of Dr. Junior's being elevated to ownership.

With regard to the buy-in of family member(s) as dentists or specialists, I have one simple rule: Handle the buy-in and later buy-out as if the family member(s) is not related.

Can Partnerships Work?

Yes, partnerships work very well provided that Dr. Senior and Dr. Junior are compatible, the practice is economically healthy, the facility will or has expand(ed) or relocate(ed)e, compensation in all forms and operating expenses are allocated fairly, the economic terms of the associate buy-in(s) and owner buy-out(s) are fair to all parties, decision-making control is agreed upon, spousal involvement is agreed upon, and Dr. Junior agrees to buy out Dr. Senior upon retirement or in the event of a catastrophe. The difficulty lies in the complexity of the partnership, which is why practicing solo or in a solo group arrangement is, in my view, a better alternative than a partnership for both Dr. Senior and Dr. Junior.

Figure 11-1

CRITERIA FOR SUCCESSFUL PARTNERSHIP

1. Dr. Junior agrees to a mandatory buy-out of Dr. Senior upon retirement in accordance with a predetermined and agreed-upon formula to account for future practice growth; incentives and disincentives are in place to ensure that the parties live up to their obligations;

2. Practice valuation and transition memorandum are prepared as early as possible;

3. There is a way out or exit that is available for any owner;

4. The patient base remains separate for each owner and any associate dentist in general practices;

5. The practice is economically healthy;

6. There are sufficient new patients and growth;

7. The existing owner(s) cannot incur a drop in compensation, unless time in practice is reduced;

8. The owners are compatible with each other;

9. The economics of the associate buy-in are fair to both or all parties;

10. Compensation and benefits are allocated fairly;

11. Decision-making control of the practice is agreed upon by both or all parties, with dispute resolution devices in place;

12. Spousal involvement in the practice is agreed upon by both or all parties in advance.

Figure 11-2

COMMON REASONS PARTNERSHIPS FAIL

1. Incorrect and unrealistic economics of the associate buy-in(s) and owner buy-out(s) ;
2. Insufficient patients and/or referral sources;
3. Disproportionate quality of clinical treatment;
4. Disproportionate productivity;
5. Disproportionate effort;
6. Varying long-range or strategic goals;
7. Failure to discuss practice business through regularly scheduled board or owner meetings;
8. Practicing in the wrong location;
9. Inefficient facility design;
10. Inability to compromise;
11. Personality conflicts and other personality issues;
12. Ineffective management and/or delegation of management duties and responsibilities, including staff training;
13. Ineffective leadership; and/or
14. Inadequate, unrealistic, outdated, or absent buy-in, operational, and buy-out agreements.

Figure 11-3

POTENTIAL ISSUES IN FUNDING RETIREMENT PLAN CONTRIBUTIONS WITH ASSOCIATE PROFITS AND COMPENSATION BASED BUY-INS

1. This mechanism assumes that associate buy-ins can be made as a compensation shift resulting in mostly a pre-tax buy-in. In a C-corporation, the compensation shift could be recharacterized to a non-deductible dividend.

2. The economics of the associate buy-ins are based on future projections of growth that may or may not occur. The associate/new owner may leave the practice if the future projections of growth are incorrect.

3. Will the practice facility face relocation to accommodate the new owner? If so, what is the projected cash flow and what will be the impact upon mandatory contributions? Will the existing facility allow for significant increases in revenues and profits?

4. If the retirement plan adopted is a defined benefit plan, significant contributions are mandatory, not optional.

5. Any defined benefit plan will need to be in effect for minimally 3 years, usually 5 years. What happens if contributions cannot be made?

6. Human behavior and theoretical outcomes greatly differ. Behavioral change is mandatory to change economic outcomes.

7. Profitability will affect income allocation.

8. Practice owners are being told that they can fund their retirement plan from the efforts of the associate/new owner. The associate/new owner and this individual's advisors may not share the same view.

9. Tax-qualified retirement plans are not for everyone. What about real estate and other investments outside of the retirement plan? This assumes that the doctor has the discipline to save outside of the tax-qualified retirement plan.

10. Practice management is crucial to the success of this mechanism to increase revenues and profitability on a consistent basis. Given the quality, quantity, and economic cost of management training, will the doctor(s) change the practice for the better?

Figure 11-4

OVERHEAD ALLOCATION CHART

Category	Practice Pays Overhead				Pro Rata Overhead			
	Dr. Senior		Dr. Junior		Dr. Senior		Dr. Junior	
1. Practice Revenue	$2,000,000		$2,000,000		$2,000,000		$2,000,000	
2. Overhead	-1,200,000		-1,200,000		-1,200,000		-1,200,000	
3. Available Compensation	$ 800,000		$ 800,000		$ 800,000		$ 800,000	
4. Doctor Revenue	x .6		x .4		1,200,000		800,000	
5. Overhead	N/A		N/A		-600,000		-600,000	
6. Doctor Compensation	$ 480,000		$ 320,000		$ 600,000		$ 200,000	
7. Doctor Compensation as Percentage of Available Compensation	$ 480,000 / $ 800,000	= 60%	$ 320,000 / $ 800,000	= 40%	$ 600,000 / $ 800,000	= 75%	$ 200,000 / $ 800,000	= 25%
8. Doctor Compensation as a Percentage of Practice Revenue	$ 480,000 / $1,200,000	= 40%	$ 320,000 / $ 800,000	= 40%	$ 600,000 / $1,200,000	= 50%	$ 200,000 / $ 800,000	= 25%

Chapter 12

WHY SOLO GROUP ARRANGEMENTS MAKE SENSE

Solo group arrangements for general practices and some specialties are an underutilized alternative to partnerships. These arrangements were invented in approximately 1979 by Dr. James R. Pride, founder of Pride Institute. In a partnership, it is essential that Dr. Junior buys the first and second half of Dr. Senior's practice. Assuming that Dr. Junior is practicing at full capacity after purchasing the first half of Dr. Senior's practice, Dr. Junior may not (probably will not) want to be obligated to buy the second half of the senior dentist's practice. A solo group arrangement solves this problem because both dentists maintain separate practices in the same facility, and it is not mandatory (but is optional) that Dr. Junior buys out Dr. Senior. An exception to a mandatory buy-out for solo group members may be for death or disability.

Associate Employment

In this model, Dr. Junior joins the practice as an associate dentist. Identical to and under the same timing as becoming a partner in the practice, Dr. Junior purchases 50% or an undivided half interest of the tangible assets of the practice and an undivided 50% interest in the practice or personal goodwill. But rather than being partners, both dentists maintain separate practices under an office-sharing arrangement. In addition, the tax issues of the three business and tax structures for partnerships are completely avoided.[64]

Buy-Out

If Dr. Junior will not agree to the obligation of buying out Dr. Senior in a partnership, the senior dentist's interest becomes almost worthless. In a partnership, if a third dentist (Dr. 3) is brought in, he or she must work with Dr. Junior. Dr. Junior will want to retain founder's rights above Dr. 3. The relationship between Dr. Junior and Dr. 3 makes it difficult to convince the third dentist to buy out Dr. Senior's interest. And because tDr. Junior will not guarantee the third dentist's loan, Dr. Senior is paid over time.

In a solo group, the original owner's (the "Original Owner") practice can be sold to a third party if the younger solo group member (the "New Owner") does not exercise the option to purchase within a short notice period. In this case, Dr. 3 is not required to become a partner with Dr.Junior/New Owner, and he or she maintains a separate practice.

Office-Sharing Agreement

Each practice operates its, his, or her dental practice separately in the same facility, employs its, his, or her own staff, to the extent they are not shared, bills its own patients, and pays its own or its share of operating expenses. Each practice operates under the terms of an office-sharing agreement in accordance with predetermined common policies and expense-sharing allocations. Expense-sharing allocations are equally shared or allocated based on collections or production of one solo group member as a percentage of all solo group members. An example of the key terms of an office-sharing agreement is designated in Figure 12-1.

[64] Prescott WP. Co-Ownership - What Works, What Doesn't and Why!, *Dent Econ.* 2015; 105(4): 106-108.

Buy-Sell Agreement

A buy-sell agreement should be in place granting the option of a solo group member to purchase the practice of a retiring or departing solo group member. If the option is not exercised in a short time, the Original Owner may sell its, his, or her practice to any dentist licensed in the applicable state under the terms of the office-sharing and buy-sell agreements with the New Owner. If the New Owner would wish or be required to leave the premises in the event of a dispute, the buy-sell agreement would provide that the New Owner would be permitted to remove such New Owner's patient charts, retain New Owner's telephone number, website(s) and domain name(s), and remove the New Owner's personal property, dental equipment, and technology. The New Owner would also receive the fair market value of any jointly owned equipment and technology as determined by a formula in the buy-sell agreement. Dental supplies and instruments would also be considered in this formula if shared; however, they are usually owned by the respective practices.

Shared Employees

In a solo group, each practice can share employees, e.g., hygienist(s) or front desk. While the hygiene function can be shared (not that it should be), I do not care for sharing front desk personnel due to scheduling priorities. Typically, the Original Owner's practice pays the shared staff to the extent the shared staff worked for the New Owner's practice, and the New Owner's practice reimburses the Original Owner's practice for the pro-rata cost.

Retirement Plans and Health Insurance

Unlike any of the three entity business and tax structures of partnership, solo group arrangements permit the practices to maintain separate retirement and health plans. To the extent that employees are shared, the prorated benefits are reimbursed by the New Owner's practice or the Original Owner's, or vice-versa. This is significant because the Original Owner and the New Owner may have significant differences in retirement and health plan design.

Summary

Solo groups provide a good alternative to partnerships because Dr. Junior/New Owner is not obligated to buy out Dr. Senior/Original Owner. Yet the New Owner can sell the New Owner's practice to a third party who becomes a solo group member with the Dr.Senior/Original Owner, not a partner. In addition, the difficult tax effects under the three business and tax structures of partnerships are completely avoided.

Figure 12-1

SOLO GROUP ARRANGEMENTS

OFFICE-SHARING AGREEMENT PROVISIONS

1. Management of the facility, decision-making procedures, and dispute resolution provisions.
2. Work schedules and use of the facility.
3. Joint and individual checking accounts.
4. Division of expenses either shared equally or based on respective practice productivity.
5. Facility maintenance.
6. Equipment repair.
7. Sharing of certain staff members as well as payment of staff compensation, fringe benefits, and retirement plan contributions.
8. Confidentiality of patient records and/or referral sources.
9. Use of telephone lines.
10. Mutual indemnification or hold harmless provisions.
11. Maintenance of current license to practice the dentist's profession.
12. Responsibility for repair of the premises other than equipment.
13. Capital and cash contributions.
14. Requirements to sublet or assign space, as well as the process to hire or engage an associate dentist.
15. Termination provisions.
16. Miscellaneous provisions, e.g., an integration clause whereby the document contains the entire agreement relative to the subject matter, possible arbitration in the event of a dispute, jurisdiction and venue provisions, and changes to the agreement must be in writing.
17. Maintenance of malpractice/liability insurance with specific coverage limits.
18. Possible requirement that any individual or entity who or that acquires the practice of a retiring or departing practice owner becomes a party to the Office-Sharing Agreement as a condition to the practice sale.
19. The dates, time, and place of respective practice owner meetings to discuss common agenda items and business.
20. Real Estate and Lease commitments — decision about who stays and who leaves in the event of a dispute.

SUMMARY AND THOUGHTS

If you are leaving practice, start planning early, understand your exit choices, and depart on your own terms. The more time you have, the better you can plan. A complete sale of assets is simple and beneficial from a tax perspective because you receive mostly capital gains and the purchaser can amortize or deduct the entire purchase price. If you plan to work for up to 7 years, hiring an associate with a complete sale in 1 to 3 years is perfect for a large or unique practice that requires purchaser mentorship. With enough production, you can work 3 or 4 years after the sale and by mutual agreement thereafter. Partnership only works when Dr. Junior commits to purchasing the second half of the practice. Three or more owner practices, while rare, result in buy-outs paid over time, as opposed to being paid in cash. Solo groups are a good alternative to partnerships because there is no mandatory buy-out of the second half of the practice. The purchaser can also deduct the assets purchased, with limited exceptions. Mergers with contingent sales work well for practices that are otherwise not salable. Finally, working for 1 or 2 more years, then closing the doors, has some merit.

For dentists or specialists entering practice, there is an additional choice in that a practice can be established. Dentists and specialists who establish a practice sometimes do so out of frustration because other practice entry options are not working out or they plan to practice in the geographic area where they are from. Establishing a practice takes 30 new patients per month and another job. If the dentist or specialist is entering into partnership, he or she should request a signing bonus to pay advisors in these complex transactions, as well as sign a confidentiality letter and insist on understanding the valuation, valuation date, and business and tax structure of the partnership before signing an employment agreement containing a restrictive covenant. As to restrictive covenants, a dentist or specialist needs to be able to work without relocating should the opportunity fail.

Live your dreams! If you can dream it, you can do it. While it may take time, don’t compromise, at least not in the long run.