Co-Ownership — Getting In, Staying In and Getting Out: The Good, The Bad and The Tax!

by William P. Prescott, E.M.B.A., J.D.
Wickens, Herzer, Panza, Cook & Batista Co.
35765 Chester Road • Avon, OH 44011-1262
Direct Dial 440/695-8067
Fax 440/695-8098
Cell 440/320-8984
Email: WPrescott@WickensLaw.com
Website: www.PrescottDentalLaw.com

Legislative Update

- Legislation Affecting Your Practice.
  - Estate Plans.
  - Employment Policies.
  - Hiring and Firing.
  - Retirement Plans.
  - IRS Priorities.
  - Corporate Practices.
    - State Legislatures Move Slow.
    - White Paper.

Legislative Update (cont'd)

- Worker Classification.
  - Associates.
  - Retired Doctors Who Continue to Work.
  - Hygienists.
  - No Harm, No Foul, Right?
  - Section 530 Relief.
- S-Corporation Distributions.
  - Social Security Wage Base or Retirement Plan Contribution Level.
  - 2009 GAO Report — $23.6 Billion Estimated Loss for Years 2003 and 2004.

Legislative Update (cont'd)

- The Effects of Health Care Reform on You, Your Family and Staff.
  - Medical Reimbursements.
  - Provisions Effective In the Future.
    - Grandfathered Status.
    - State Health Care Exchanges — 2014.
  - Written Health Plan Requirement.
  - Summary Plan Description Requirement.

Succession Planning For Co-Ownership

- When Can I Afford to Retire?
- How Long Do I Plan to Work Full-Time?
- Do I Want or Need a Partner?
- What Would I Do With My Time If I Didn't Work or Work Less?
- My Facility — Do I Need to Relocate or Expand to Hire an Additional Dentist or Specialist?

How Do I Do This?

- Assemble Advisory Team With Experience and Who Interact Well With Each Other.
- Understand How All Advisors Are Paid.
- Determine Exit Choice With / Through Your Advisory Team.
- Authorize Preparation of Practice Valuation.
- Authorize Preparation of Associate Employment Agreement.
- Authorize Preparation of Letter of Understanding/ Preparation of Agreements.
- Authorize Preparation of Confidentiality Letter for Candidates.
- Conduct Candidate Search.
- Conduct Candidate Interviews.

How Do I Locate My Successor After My Exit Choice Is Determined?

- Professional Advertisements.
- Practice Brokers.
- Dental Schools.
- Advisors.
- Dental Fraternities.
- Even Sunday Newspapers.

Assess Practice Succession Options Before Entering Into Co-Ownership

- Complete Sale.
- Hire Associate with Later Sale.
- Co-Ownership.
- Solo Group Arrangement.
- Merger.
- Walk Away.

Complete Sale Versus Co-Ownership

- Why Would You Admit a Partner?
- The Buy-In is a Give-Away — It Merely Only, and Hopefully, Sets-Up Your Buy-Out.
- What is the Effect on Your Compensation With a Partner?
- Is There Enough Production?
- How Effective Are Your Systems?

Hire Associate With Later Sale

A Very Viable Alternative For Seven Years of Continued Practice

- Locate Associate.
- Your Due Diligence.
- Termination Option for Either Party for One Year.
- Authorize Preparation of Valuation Report.
  - Valuation Date — One Year Out After Associate Employment Starts?
  - Mutually Agreed Equipment and Technology Purchases Before the Sale.
- Earnest Money Deposit In the Form of a Promissory Note.
- Letter of Understanding.
- Authorize Preparation of All Agreements.
- Importance of Restrictive Covenant in Associate Employment Agreement.
  - Buy-Out Provision?
- Payment Terms.
- Your Continued Employment.
  - If You Need to Continue to Work, Maybe You're Not Ready To Sell?
  - Advantageous for Large and "Leader" Oriented Practices.

Co-Ownership

- Reasons Why Co-Ownership Relationships Succeed.
  - Key — Quality People.
- Reasons Why Co-Ownership Relationships Fail.
  - Key — Some Trigger Exists Whereby the Relationship Should Not Have Been Entered Into.

Solo Group Arrangements Versus Co-Ownership

- No Mandatory Buy-Out of Second Half of Practice.
- Autonomy of Practices.
- Favorable Tax Benefits Because the Anti-Churning Rules Do Not Apply For Practices Formed Before August 10, 1993, Except For Family Members.
- Separate Retirement and Health Plans.
- Sharing of Employees.

Merger

- Provides Additional and Important Associate / New Owner Production.

Walk Away in Co-Ownership

- Happens Where the Relationship With the New Owner Fails, in Certain Geographic Areas and In Unique and Specialty Practices.
- The Economics Are Okay Though.

Valuations in a Fractional Sale

- New Owner Will Not Be Willing to Incur a Pay Reduction.
- Pay the Lender(s).
- Pay Operating Expenses.
- Within a Measured Period of Time.
- Accountant's Confirmation of the Valuation Report.
- Risky for Dr. Senior Due To Internal Financing, Unless Dr. Senior Guarantees Dr. Junior’s Loan.
- Valuations are Prepared in a Tax-Neutral Manner.

Valuations in a Fractional Sale (cont'd)

- Accounts Receivable Versus Prepaid Contracts in Orthodontic Practices
- What Percentage of Patients Will Stay and Referral Sources Refer?
- What Percentage of Last Year's Collections Should Be Used to Value the Practice If Purchaser Expects Some Reduction of Patients or Referral Sources?

Hiring or Becoming the Associate

- The Associate Interview Process.
- Spouse in the Practice.
- Length of Association, 1-3 Years, Then What?
- When Will You Relocate or Expand?
- Proposal for Employment.
- Worker Classification.

Hiring or Becoming the Associate (cont'd)

- Key Employment Agreement Provisions.
  - Restrictive Covenant.
    - When Does it Start?
    - A Buy-Out?
    - Associate's Patients.
  - Compensation.
    - Collections.
    - Adjusted Production.
    - Base Salary vs. Draw
    - Benefits, Insurances and Direct Business Expenses.
    - Bonuses, Based on Production or Discretionary?
  - Termination Provisions.
    - Notice.
    - Cause — Cure Period?
    - Death, Disability.
    - Loss of License.
- Associate to Ownership.

Forms of Co-Ownership

Practice Groups	Characteristics
1. Two Doctor Practice	• Most Common Form of Co-Ownership
2. Specialty Group	• Buy-Outs are Usually Deferred Compensation • First to Get Out in Best Position
3. Multi-Specialty Group	• Need Same Specialist for Buy-Out
4. Private Practice — General and Multi Specialty Medical Building/Condo	• Perfect
5. Group With More Than One Family Member	• Third-Party Needs a Buy-Out of the Restrictive Covenant
6. Part-Time Group	• Quasi-Office Sharing Arrangement
7. Corporate Group	• Limited Market for Interest
8. Large Practice — General Dentistry	• Tough to Keep Revenue Consistent • Tough for Younger Owners to Get Out
9. Solo Group	• Buy-Outs are Not Mandatory, Except for Catastrophes
10. Multiple Locations	• Founding Owner, Plus Other New Owners and Separate Entities
11. Consultant and Dentist Corporate Groups	• The Dentist is the Custodian of the Patient Charts
12. Specialists Purchasing General Practices	• Goal — to Increase Referrals and Earn a Profit

Practices Consisting of Two or More Owners Are Becoming More Common as the Number of Practices That Expand or Relocate Increase.

We Can't Deal With the Buy-In, Unless We Deal With the Buy-Out

- Three Categories in Any Business and Tax Structure of Co-Ownership.
- Buy-Ins Are Typically Owner Financed, Unless a Guaranty – Buy-Outs Paid in Cash?
- Because Practice Valuations Are Prepared in a Tax-Neutral Manner, the Business and Tax Structure Will Increase or Decrease the Buy-In Purchase Price and Buy-Out Formula.
- Business and Tax Structure Will Increase or Decrease the Buy-In Purchase Price and Buy-Out Formula.
- Business and Tax Structure Should Be Determined Prior to the Associate Commencing Employment — or a Fight Will Follow.
- Associate Employment Provisions, Equity Purchase Provision, Letter of Understanding or All Agreements Prepared — Is the Owner's Succession Plan Figured Out? When? The Earlier the Better!
- Will or Should Dr. Junior Incur a Pay Reduction?

Buy-In Business and Tax Structures Are Similar, But Not Identical, to Buy-Out Business and Tax Structures – The Three Methods

- Purchase and Sale of Stock/Voting Units Excluding Goodwill, Coupled With Compensation Adjustments for the Buy-In and the Entity's Purchase of Personal Goodwill or Payment of Deferred Compensation for the Buy-Out.

- Three Entity Method – an LLC of Professional Corporations or Individual Doctors as Members. Which Entity/Individual Owns What? August 10, 1993, The Big Day!

- Purchase and Sale of Stock/Voting Units, Reduced by the Tax Detriment to Purchaser Purchasing Stock or a Membership Interest in After-Tax Dollars – The Only Method Always Without Risk?

Your Silent Partner — The IRS
Buy-In Tax Issues

- **Risk 1** — Compensation Shifts.
- **Risk 2** — The Anti-Churning Rules.
  - Examples 17 and 20 of the Ginsburg Treatise.
  - Example 19 — IRC Reg. 1.197-2(k) Example 19.
- **Risk 3** — S-Corporation Distributions in Three Entity Method – Is This Safe?
- **Risk 4** — Worker Classification.
- **Risk 5** — Individual Purchase of Personal Goodwill.

Your Silent Partner — The IRS
Buy-Out Tax Issues

- **Risk 1** — Personal Goodwill Relating to Co-Ownership.
- **Risk 2** — Deferred Compensation.
- **Risk 3** — The Anti-Churning Rules Apply!
- **Risk 4** — Worker Classification.

Stock Excluding Goodwill

Buy-In

	Advantages	Disadvantages
Stock excluding goodwill, coupled with compensation shift Stock excluding goodwill, coupled with purchase of personal goodwill individually *** An individual's purchase of personal goodwill in place of the compensation shift is not amortizable**	● Inexpensive and affordable for the new owner as a pre-tax buy-in	● Potential tax risks for C-corporations ● Ordinary income to seller ● Minimal security for payment ● Second owner affected by senior owner's sale of stock to a third doctor ● Contingent and unknown liabilities

Buy-Out

	Advantages	Disadvantages
Stock excluding goodwill, coupled with corporation's purchase of personal goodwill or payment of deferred compensation *** An individual's purchase of personal goodwill in place of the corporation's purchase or payment of personal goodwill is not amortizable**	● Arguably, capital gains to seller, relative to corporation's purchase of personal goodwill ● Deferred compensation inexpensive and affordable to Dr. Junior, but not as beneficial to seller as corporation's payment of personal goodwill ● Buy-out paid in cash, except for deferred compensation, if a two owner practice	● Potential tax risk — low stock value / purchase and sale of personal goodwill ● Departing owner cannot be subject to a restrictive covenant ● Little security for payment of deferred compensation ● Contingent and unknown liabilities

Three Entity Method

Buy-In

	Advantages	Disadvantages
Three entity method	• Amortizable, if practice formed after August 10, 1993 • Owner flexibility in business expense allocation • Tax-neutral	• Goodwill non-amortizable, if practice formed before August 10, 1993 • Three tax returns • All employees are covered in retirement plan

Buy-Out

	Advantages	Disadvantages
Three entity method	• Amortizable if the practice is formed after August 10, 1993 • Owner flexibility for business expense allocation	• Goodwill not amortizable if practice formed before August 10, 1993 • Three tax returns • All employees are covered in retirement plan

Stock Including Goodwill

Buy-In

	Advantages	Disadvantages
Stock in after-tax dollars	• No tax risk • Simple and straightforward • Capital gains to seller • Basis to purchaser as a later benefit • Security for payment	• Expensive • After-tax dollars to purchaser • Contingent and unknown liabilities

Buy-Out

	Advantages	Disadvantages
Stock in after-tax dollars	• No tax risk • Simple and straightforward • Capital gains to seller • Basis to purchaser as a later benefit • Buy-out made in cash if a two owner practice	• Expensive • After-tax dollars to purchaser • Contingent and unknown liabilities

Buy-Sell Agreements

- Triggering Events.
- Optional Buy-Outs.
- Termination of Employment by Dr. Senior or Dr. Junior.
- Rights ~~of~~ First Refusal.
- Mandatory Buy-Outs.
- Use of Insurance.
- Cash Versus Payments Over Time.
- Purchase Price Determination Under Each Triggering Event.
  - Formula.
  - Agreed Value.
  - Most Recent Appraisal.

Buy-Sell Agreement Matrix

TRIGGERING EVENT		Contract Terms						
					Nature of Parties' Obligations			
		Purchase Price (a)	Payment Terms (b)	Purchase of Insurance (c)	Practice/ Remaining Owner(s) Must Buy	Practice/ Remaining Owner(s) have Option to Buy	Departing Owner Must Sell	Departing Owner has Option to Sell
	Death							
	Permanent Disability							
	Election to Transfer by Owner							
	Termination of Owner's Employment							
	Retirement							
	Dispute							

(a) Purchase Price Options:

1. Stock In After-Tax Dollars
2. Stock Excluding Goodwill, Coupled With Corporation's Payment of Personal Goodwill or Payment of Deferred Compensation.
3. Three Entity Method

(b) Payment Term Options:

1. Cash
2. Promissory Note
3. Cash Down Payment and Promissory Note

(c) Purchase of Insurance to Fund Obligation:

1. Life Insurance
2. Disability Buy-Out Insurance

Two Or More Owner Practices

- Buy-Outs Usually Payable On Time and Not in Cash.
- Those First to Leave Are in the Best Position.
- What Are the Obligations for the Remaining Doctors?
- Business and Tax Structure?
- Specialty Versus General Practices.
- Multi-Specialty Practices.
- The Real Estate and Facility Lease(s).
- Multiple Locations.

Operations

- Decision-Making Control.
  - Close Corporation Statutes or 51% / 49% Versus 50% / 50% Control.
  - Certain Decisions Require Unanimous Consent.
- Dispute Resolution Mechanisms.
- Allocation of Compensation.
  - Percentage of Collections of an Owner As a Percentage of Collections of All Owners.
  - Fixed and Variable Costs Allocated Equally to Each Owner and Available Compensation Allocated By Respective Collections.
  - Some Percentage Based Upon Ownership.
  - Management Fees in Exchange for Management Services.
  - Payment of Benefits, Insurances and Direct Business Expenses.
- Necessity For Accountant to Understand Compensation Allocation Attached as a Schedule to the Owner Employment Agreements.
- Debt.
- Retirement Plan Contributions.

Example — Compensation Allocation

- For each consecutive month of the Employment Term, Employee shall be entitled to Basic Salary equal to:
  - the monthly collected revenues attributable to professional dental services rendered to Corporation's Patients by Employee;
  - less fifty percent (50%) of Corporation's fixed overhead expenses (prorated on a monthly basis);
  - less fifty percent (50%) of Corporation's variable overhead expenses (prorated on a monthly basis); and
  - less all direct business expenses (prorated on a monthly basis) incurred by Corporation and attributable to Employee's aforementioned professional dental services on behalf of Corporation, which monthly collected revenues, fixed expenses, variable expenses, and direct business expenses shall be determined by Corporation's accountant and approved by Corporation's Board of Directors.
- Equal Compensation Percentage / Distributions.

Overhead Allocation Chart – 1

Category	Practice Pays Overhead: Dr. Senior		Practice Pays Overhead: Dr. Junior		Pro Rata Overhead: Dr. Senior		Pro Rata Overhead: Dr. Junior	
1. Practice Revenue	$1.00		$1.00		$1.00		$1.00	
2. Overhead	- .6		- .6		- .6		- .6	
3. Available Compensation Percentage	.4		.4		.4		.4	
4. Doctor Revenue	x .6		x .4		.6		.4	
5. Overhead	N/A		N/A		- .3		- .3	
6. Doctor Compensation	.24		.16		.3		.1	
7. Doctor Compensation as Percentage of Available Compensation	.24 / .4	= 60%	.16 / .4	= 40%	.3 / .4	= 75%	.1 / .4	= 25%
8. Doctor Compensation as a Percentage of Practice Revenue	.24 / .6	= 40%	.16 / .4	= 40%	.3 / .6	= 50%	.1 / .4	= 25%

Over time, Dr. Junior rarely produces more than Dr. Senior. In other words, the percentages change very little over 20 years.

In a solo group, some expense categories will be equally allocated and some on the basis of productivity or collected revenue. However, each practice pays its own staff (with some sharing), supplies (except for common supplies), lab, direct business expenses, insurances and benefits.

Where the practice pays the Overhead, each owner is allocated compensation equal to the respective owner's collections, multiplied by the Available Compensation Percentage.

Overhead Allocation Chart – 2

Category	Practice Pays Overhead: Dr. Senior		Practice Pays Overhead: Dr. Junior		Pro Rata Overhead: Dr. Senior		Pro Rata Overhead: Dr. Junior	
1. Practice Revenue	$2,000,000		$2,000,000		$2,000,000		$2,000,00 0	
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%

Practical Considerations

- Employment of Family Members as Doctors and Staff.
- Optional Versus Mandatory Buy-Outs.
- Owners Approximately the Same Age.
- Three or More Doctor Practices — Doctor Two Does Not Want to be Affected by the Buy-Out of Doctor One by Doctor Three.
- Lease Assignments, Renewal Options and Building Ownership.
- Relocation or Expansion – It Will Happen!
- Cost of Technology and the Importance of a Return on Investment.
- Advisor Responsibility to Inform the Doctor(s) of Any Tax Risks?
- Post-Retirement Employment.

Dispute Resolution – Finding Middle Ground

- Board/Member Meetings.
- Annual Meetings.
- Close Corporation Agreements.
- Third Party Arbitrator.
- Dissolution.
- “Russian Roulette” Provisions.
- Termination of Dr. Junior's Employment With Disincentive.
- Buy-Sell Agreements.
  - Who Stays, Who Leaves?
  - May Depend Upon Age.
  - Pay for Half, You Can Compete.
- Litigation. Emotional, Costly and Lengthy — The Last Alternative!
- Provisions Included in Shareholder Agreements.
- Corporate Division.

Corporate Division

Dr. Smith and Dr. Jones have practiced for 10 years as shareholders in their dental specialty practice and no longer desire to practice with each other due to production disparities. Drs. Smith and Jones meet the requirements under Section 355 of the Tax Code to implement a corporate division of their C corporation. The doctors have one practice facility and after negotiations, it was decided that Dr. Jones would relocate Dr. Jones' practice to another location and Dr. Smith would retain the existing facility. In exchange for Dr. Jones' shares of stock, Dr. Jones will form a new corporation and will receive half of the assets of the C corporation that Dr. Smith will retain, plus a specified sum of cash for the budgeted cost of relocation.

Considerations:

1. Number of Locations.
2. General or Specialty Practice?
3. Are Section 355 Requirements Met?
4. Real Estate.
5. Separate Patient Base for Each Shareholder in a General Practice.
6. A Real Nice Letter to Patients/Referral Sources.
7. Who Stays/Who Relocates?
8. The Alternative Is a Court Ordered Dissolution.
9. Debt.

Solo Group Arrangements and Mergers

- Solo Group Arrangements as an Alternative to Co-Ownership.
  - Amortization of Goodwill Permitted, Except for Family Members.
  - Usually, No Mandatory Buy-Out.
  - Sharing of Staff Permitted.
  - Separate Retirement Plans Permitted.
  - Usually Not for Dental Specialists.
  - Maintain Separate Patients.
- Mergers.
  - Always Look.
  - What to Charge and How?
  - Is This a Later Mandatory Buy-Out?
  - What If You Don't Like Each Other?
  - Who Stays, Who Goes?
  - Contingent Sale — How Does This Work?

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 upon 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 doctor's profession.
12. Responsibility for repair of the premises other than equipment.
13. Capital and cash contributions.

Solo Group Arrangements / Office Sharing Agreement Provisions (cont'd)

14. Requirements to sublet or assign space, as well as the process to hire or engage an associate doctor.
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, changes to the agreement must be in writing.
17. Maintenance of malpractice/liability insurance with specific coverage limits.
18. Any individual or entity who or which acquires the practice of a retiring or departing practice owner may be required to become 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 — who stays and who leaves in the event of a dispute.

Example — Case Studies

- Unincorporated Dentist or Specialist Hiring New Dentist or Specialist to Become Successor.
  - Form S-corporation, Wait One Year for Capital Gains Treatment.
- Dentist or Specialist is Organized as a C-Corporation and Hires Successor.
  - Consider S-election if Five Years to Complete Sale.
- Father/Mother Admits Son/Daughter as Owner After Associateship.
  - Treat Son / Daughter as a Third Party.
  - Production Issues.
- Husband and Wife Dentists Admit Dr. Three as Owner After Associateship.
  - So Long as Practice Interest is Fully Paid, Allow Termination of Restrictive Covenant.
  - Buy-Sell Price Excludes Goodwill Previously Paid and Includes Only Tangible Assets — Pro Rata Value.
  - Keep Separate Patients.

Example — What Do You Think?

You purchased or established your practice in 1990. You are very busy, have already relocated, have made the decision to hire an associate and are contemplating co-ownership in the future. You plan on practicing full-time for another 10 years. The associate employment agreement is prepared, the practice valuation is completed and your exit strategy is defined.

Question A

When should the ownership agreements be prepared?

Question B

What business and tax structure should be used?

1. Purchase and Sale of Stock in After-Tax Dollars Adjusting Adjusting the Purchase Price?
2. Stock Excluding Goodwill?
3. The Three Entity Method?
4. A Solo Group Arrangement?

Maintaining Your Practice Entity

- Liability Protection and the Practice Entity.
- If C-Corporation, Should We Elect S-Status?
- The Practice Versus Real Estate.
- Corporate / Entity Maintenance.

See For-Profit Year-End Matter Information Sheet

Summary and Thoughts

- **Start Planning Early** — Understand Your Exit Choices and Leave on Your Terms.
- **Complete Sale** — Simple, You Receive Mostly Capital Gains and the Purchaser Can Deduct the Purchase Price.
- **Hire Associate With Later Sale** — Avoids Complexities of Co-Ownership and Perfect for Large or Unique Practices that Require Purchaser Mentorship. Good For Seven Years Out; Sell in Three, Work for Four, or Vice-Versa.
- **Co-Ownership** — Works Only Where Dr. Junior Commits to Purchasing the Second Half of Your Practice or Large Practices Already in Co-Ownership. Good For More Than Seven Years Out.
- **More Than Two Doctor Practices** — Buy-Outs Are Usually Not Paid in Cash.
- **Solo Groups** — Good Alternative to Co-Ownership Because There is No Mandatory Buy-Out of the Second Half of Your Practice.
- **Mergers** — Mostly Contingent Sales and Works Well For Practices Not Otherwise Salable. Can Increase a New Owner's Production.
- **Work One or Two More Years, Then Close the Doors** — This Has Merit and a Good Economic Outcome in Certain Situations.

Summary and Thoughts (cont'd)

Do Not Take Unnecessary Tax Risks,
Get Bought Out In Cash and
Don't Forget Your Other Partner —
the IRS!