Transitions Roundtable

We ask two experts the same question on a complex issue.

QUESTION:
I want to hire an associate and use a buy-out formula to transition the practice. Where should I start?

WILLIAM P. PRESCOTT, JD, EMBA

The transition buy-out formula is dependent upon how long the practice owner plans to work prior to the sale. If the practice owner wants to work fewer than seven years, he or she should consider hiring an associate, sell the entire practice in one to three years, and continue to work with the new owner for three or four years if the patient base is sufficient, and by mutual agreement thereafter. Should the new owner terminate the former owner's employment without cause, the restrictive covenants could become null and void.

The purchase price is determined after the associate works one year in the practice on a full-time basis and is increased by the cost of replacement equipment and mutually agreed upon equipment and technology. It is then depreciated over a 10-year straight-line basis.

The advantage of a complete sale is that there is one owner and the complexities of co-ownership can be avoided. In addition, the parties receive favorable asset treatment, which means the new owner can deduct all assets purchased and the selling owner will receive primarily capital gains. It's a win-win for both.

If the doctors enter into co-ownership, there are three choices for the buyout formula in light of a fixed buy-in price: formula, appraisal, and fixed price. I usually recommend a formula because it accounts for growth or decline.

Appraisals are costly, take time, and values vary significantly among appraisers. If used, the appraisal methodology should be specified, and the buy-out agreement should provide that the last appraisal will control if a new appraisal is not obtained. Fixed price is used when the departing owner plans to leave within a relatively short time.

The formula, appraisal methodology, or agreed value should consider whether the business and tax structure of the co-ownership benefits the departing or remaining owner in that it needs to be tax-balanced so that one owner does not receive a tax benefit to the detriment of the other.

It is not only important to consider how the associate enters the practice, it is also vital to consider how the buy-out works in light of how long the existing owner plans to work.

WILLIAM P. PRESCOTT, JD, EMBA, of Wickens Herzer Panza in Avon, Ohio, is a practice transition and tax attorney and former dental equipment and supply representative. His most recent book is *Joining and Leaving the Dental Practice, Third Edition*, available at success.ada.org. Contact Prescott at (440) 695-8067 or wprescott@wickenslaw.com.

ALLEN SCHIFF, CFE, CPA, is a founding member of the Academy of Dental CPAs. This group of very knowledgeable CPA firms specializes in practice management services for the dental industry. He serves on the ADCPA executive committee and is the current president of the ADCPA. Reach him at (410) 321-7707 or aschiff@schiffcpa.com.

ALLEN SCHIFF, CFE, CPA

There are so many variables to consider. Some of the immediate questions that come to mind are: When do you hire an associate? When is the time for an associate? How do you know it's time for an associate? As you can see, a lot of this decision has to do with timing.

I'm sure as you approach this point in your career many thoughts run through your mind that not only include timing but the impact this decision will have on your earnings, how the team will feel about your decision, and if you offer a partnership, how will the practice value be determined?

As a dental CPA, I use a rule of thumb for most general practices. I like the practice to be collecting $1,200,000 on an annual basis before considering adding an associate. The allocation of the $1,200,000 would be $900,000 for the doctor and $300,000 for the hygiene department.

I am of the opinion that if you bring in an associate before you reach these dollar thresholds, then you are just sharing and splitting the profits with another professional. Otherwise, you could just be doing the dentistry yourself and sharing your own profits with yourself.

You may want to consider including your team in the important search for an associate. Many of our clients have invited the proposed associate into their offices to shadow the office, meet the team, and feel the office culture and environment before a formal offer.

As you go through the associate search, my suggestion is to freeze the value of the practice before the associate joins. Why? Think of it from the associate's perspective. If the associate is incentivized to produce and generate additional dentistry, what do you think is going through his or her mind during this critical time? The person is thinking, "Although I'm producing now and getting paid for such production, what happens when it's time for me to buy in? I'm creating a larger buy-in for myself." This a disincentive to produce!

In order to get around this dilemma, I suggest you and the associate agree to freeze the value at the date of hire. Doing so creates the understanding at the beginning that this will not be counterproductive, and it will create clarity, understanding, and set the expectations of the parties. DE