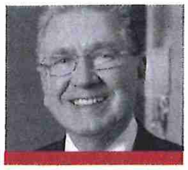

PRESCOTT'S PERSPECTIVE ON TRANSITIONS

William P. Prescott, JD, EMBA

Setting a buy-out price without appraisal; collections levels and hiring an associate

QUESTION:

My son has been an associate in my practice that operates as an S-corporation. Over the next seven years, my son will purchase all of my stock from my corporation. According to the CPA, the purchase of stock from my corporation will be treated as capital gains to me. Following the purchase, I will continue working for my son. I had an appraisal of my practice completed at the end of calendar year 2015 and do not plan to authorize another at this time. **How can we set my buy-out price without having another appraisal completed?**

ANSWER:

While it is always advisable to have an updated appraisal, your buy-out can be calculated by determining the available profit in all forms. Profit in all forms means payroll and S-corporation distributions to your son, as well as benefits, payment of liability insurance, dues, and continuing education costs for both you and your son. Therefore, determine your son's compensation requirements over the next seven years. Next, determine your compensation requirements while you continue to work. The remaining profit is what's left over to pay you in each of the seven years. Thus, the more compensation that you and your son are paid, the less you will receive for your buy-out.

As an example, if average revenue over the next seven years is anticipated to be $1,500,000, and if the profit in all forms is 40% or $600,000, and if you and your son collectively receive 30% of collections or $450,000, the remaining profit for you is $150,000 per year. This amount over seven years equates to $1,050,000.

Because your corporation, now owned by your son, cannot deduct the payment for stock and you receive all capital gains, your CPA should consider adjusting the purchase price downward to ensure that the purchase and selling price is tax neutral for both of you.

SUMMARY AND THOUGHTS

It's always advisable to have an updated appraisal that considers current collections and expenses. However, without a current appraisal, the remaining profit above your son's and your compensation in all forms is what's left for your son to pay for your corporation over seven years, adjusted by your CPA to be tax neutral.

QUESTION:

I am a general dentist planning to retire in approximately two years and am considering searching for an associate to buy my practice. **What level of collections should my practice meet to proceed in hiring an associate,** given my current collection level of approximately $800,000 per year and my working four days per week? What is the valuation process for selling my practice to my associate in the future? And what if after two years the associate does not work out?

RESPONSE:

Given the number of days you work per week, hiring an associate now would result in a pay reduction for you. Unless you plan to reduce your work schedule, it may be best to postpone the candidate search until closer to the time when you are ready to sell your practice, when the candidate search would be for a purchaser.

However, if your practice collections grow to between $1,000,000-$1,300,000 per year, possibly due to pent-up demand, hiring an associate with a later sale in two years can work very well. Your practice would be valued as of the date the associate is hired as a baseline value and again one year after the associate is employed on a full-time basis.

You could also authorize a valuation to be prepared as of the date the associate is hired and again in two years or the end of the calendar year immediately preceding your retirement and then average the values. The value would be increased to include the cost of mutually agreed-upon dental equipment and technology purchased prior to your retirement and any future purchases due to breakdowns/replacement as determined by you. The additional cost would be calculated on a 10-year straight-line basis. For example, if the equipment cost $40,000, the fair market value purchased two years prior to your retirement would be $32,000 or a $4,000 per year reduction.

You need safeguards in place in case the associate relationship does not work out. To allow time for you and the associate to initially assess each other's integrity, abilities, and efforts without any obligation for you to sell your practice or the associate to buy it, consider a six- or 12-month disengagement period. Should the associate relationship prove unsuccessful, the associate would remain subject to the restrictive covenant provisions contained in the associate employment agreement. Your choice is to either search for another associate or wait and sell your practice outright when you're ready.

Assuming that the associate relationship is successful, after the disengagement period, you must sell and the associate must buy your practice, with the exception of specified triggering events, such as the associate's death, disability, or loss of license, etc. However, should you die or become disabled, the closing date is moved up. You and the associate would have mutual default provisions in the sale and purchase agreements, and any defaulting party in breach of contract would also be subject to a promissory note, fully payable in the sum of $50,000-$100,000.

SUMMARY AND THOUGHTS

Hiring an associate with a later sale works well if the practice collections are sufficient so that you do not incur a pay reduction, unless you are willing to reduce your time in the practice. Authorize a valuation as of the date the associate is hired and again one year after the associate works on a full-time basis, or—as an alternative—as of the date the associate is hired and at the end of the calendar year immediately preceding the retirement. Then average the values. If after two years the associate does not work out, safeguards should be in place. **DE**

Hiring an associate with a later sale works well **if the practice collections are sufficient** so that you do not incur a pay reduction, unless you are willing to reduce your time in the practice.

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