PART TWO

Practice values: Now what's it worth?

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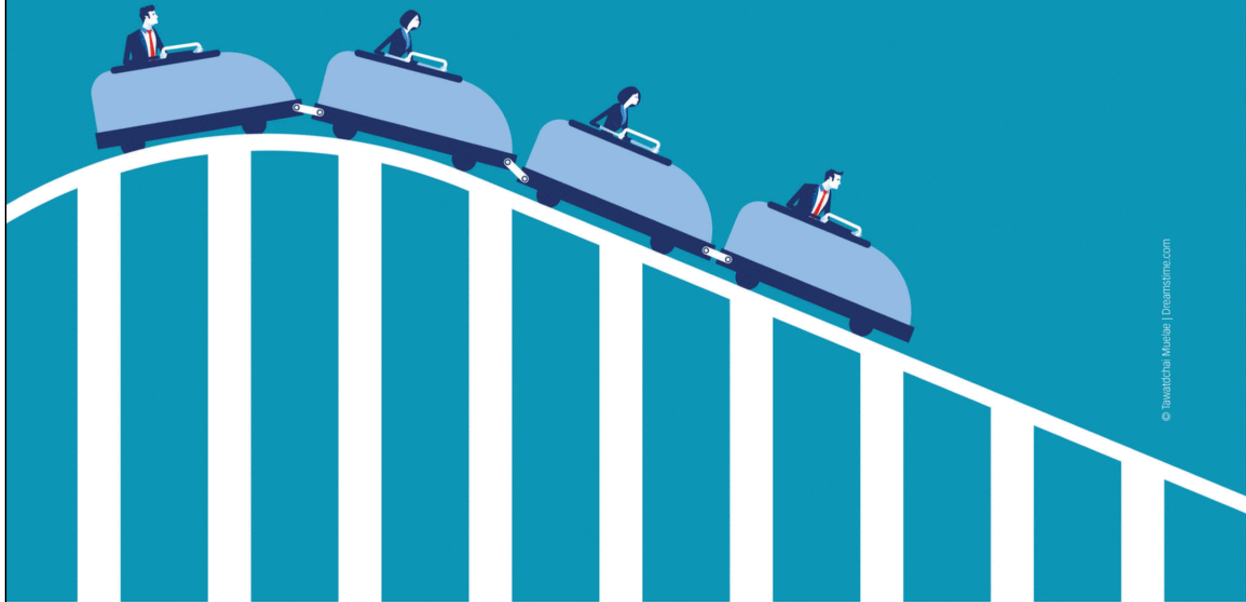

ASSOCIATE BUY-IN VALUE IN A PARTNERSHIP

For an associate buy-in, consider valuing the practice at the baseline date when the associate began employment and again one year after the associate has worked on a full-time basis. After the value is calculated, it is increased at the buy-in for the cost of mutually agreed upon equipment and technology—or replacement due to breakdown—as determined solely by the practice owner. The equipment and technology value can be determined on the basis of a 10-year, straight-line depreciation. However, if social distancing and other new guidelines remain in place as a result of the COVID-19 crisis, practice values could decline unless effective protocols are implemented to maintain patient flow at precrisis levels.

Editor's note: In the second of this two-part article on practice valuations, Mr. Prescott discusses partnership values and the related tax issues. Part one, which discussed practice values in the current environment, can be found at dentaleconomics.com.

BREAK-EVEN ANALYSIS FOR PARTNERSHIPS

Once the associate buy-in value is determined, it is important to assess when the associate can afford to begin the buy-in. A buy-in date based on consistent associate performance should be considered. Dr. Junior should earn a slight pay increase as an owner, be able to pay his or her share of the operating expenses, and pay for his or her practice interest within a measured period of time, hopefully within seven years.

BUY-OUT VALUES IN A PARTNERSHIP

Once the associate becomes a partner, the buy-out value is often calculated by formula, and each triggering event of death, disability, termination of employment, or retirement may have a different formula to calculate value. Other methods of valuing a partner

buy-out are a fixed price equal to the buy-in price, if the owner's buy-out or anticipated retirement is relatively soon, and appraisal. If the buy-out is determined by appraisal, the appraisal method should be specifically defined in the buy-sell agreement, and the buy-sell agreement should specify that if no appraisal is prepared, the last appraisal or the buy-in price will control.

CURRENT STATUS OF BUY-OUTS IN PARTNERSHIPS

Dr. Senior may elect to retire due to the pandemic, and Dr. Junior may be nervous about the buy-out obligations, regardless of mandatory buy-out provisions based on formula, fixed price, or appraisal. Dr. Junior may even contemplate leaving the partnership, even though there should be and usually is a significant reduction to Dr. Junior's buy-out value.

MINORITY INTERESTS

Some large dental practices are planning to sell to a corporate practice. In these situations, a worthy associate may purchase a minority interest. The reason that owners of large practices consider selling minority interests is to retain doctors because as a minority owner, compensation is greater than compensation for an associate. Nevertheless, the majority owner should retain the ability to sell the entire practice to whomever he or she chooses. The good news for Dr. Junior, who holds a minority interest, is that he or she will share in the anticipated economic windfall.

Where less than a 50% interest in a practice is offered, advisors for Dr. Junior may propose a minority interest discount to the value, which is almost never acceptable to Dr. Senior or Dr. Senior's advisors. One resolution to minority interest discounts is to place provisions in the owner agreements delineating those decisions that require unanimous consent of the owners. However, those owners who are growing or adding additional practices should be leery of unanimous consent provisions, and incoming minority owners should trust the existing owner's vision or seek another opportunity.

BALANCING THE TAX EFFECTS IN PARTNERSHIPS

Valuations of dental practices are usually calculated on a tax-neutral basis. Tax-neutral means without regard to whether Dr. Senior or Dr. Junior receives favorable tax treatment. Where one party receives favorable tax treatment and the other does not, the value of the practice should be adjusted to make the transaction tax neutral. Surprisingly, dental appraisers appear to be evenly split on the point of tax balancing.

For the purchase and sale of stock inclusive of goodwill, the value is reduced because Dr. Junior cannot deduct or amortize the purchase price for the buy-in or the later buy-out of Dr. Senior. The effect is that Dr. Junior pays Dr. Senior in after-tax dollars.

Where stock excludes goodwill and a compensation shift is used for the buy-in and deferred or continued compensation for Dr. Senior's buy-out, the purchase price is increased by the tax differential because Dr. Senior receives ordinary income rates and an interest component. The effect for Dr. Junior is a pre-tax buy-in and full deductibility for the payment of deferred compensation to Dr. Senior for the buy-out. The buy-out benefits Dr. Junior and any other remaining owners.

However, for Dr. Senior's buy-out, some advisors may try to seek a tax-neutral effect by replacing deferred compensation with Dr. Junior's purchase of personal goodwill. If it's truly personal, it should be taxed as capital gains rather than ordinary income to Dr. Senior. In such a case, no upward adjustment of the purchase price would be necessary.

In order to calculate goodwill as personal, the seller cannot have a restrictive covenant with his or her corporation but must have a restrictive covenant with the purchaser.[1] However, the seller's and purchaser's corporation is one and the same. Thus, the use of personal goodwill in a partnership is inadvisable.

When the three-entity method is used, which is a partnership of S corporations or other practice entities, the tax treatment is favorable to both parties, so no adjustment is made. Dr. Senior receives primarily capital gains and some ordinary income for depreciated equipment value and Dr. Junior can deduct all assets purchased as in a complete sale and purchase.

Unfortunately, if the practice was formed prior to August 10, 1993, the goodwill is not deductible to Dr. Junior for either the buy-in or the buy-out of Dr. Senior or for family members, even in a complete sale.[2] While IRC Reg. 1.197-2(k) provides complex guidance on avoiding the anti-churning rules of IRC Section 197, Dr. Junior must wait one year before becoming a partner. There are also specific anti-abuse rules that allow the IRS to recast the transaction if it deems Dr. Junior's buy-in was structured to avoid payment of taxes.[3]

ADDITIONAL THOUGHTS

Asset treatment is tax-neutral and beneficial for both the seller and purchaser. Not so with partnerships in which the business and tax structure usually makes the tax applicable to either the junior or senior owner disproportionate. The tax differential makes it important for the buy-in price and buy-out formula to be adjusted upward or downward. But of equal importance is the anticipated level of revenue, operating expenses, and profitability at the time of any owner buy-in or buy-out. **DE**

REFERENCES

1. Martin Ice Cream Co. v. Commissioner. 110 T.C. No. 189 (1998); Norwalk v. Commissioner, T.C. No. 1998-279; Howard v. U.S., 2010 WL 3061626 (E.D. Wash.), 9th Cir. (2010); Solomon v. Commissioner, T.C. Memo 2008-102.
2. Prescott WP. Strategically assessing practice exit and entry choices. *Dental Economics.* September 7, 2019. https://www.dentaleconomics.com/practice/article/14071520/strategically-assessing-practice-exit-and-entry-choices-part-one
3. Intangibles. Internal Revenue Code Section 197(j). IRS. https://www.irs.gov/businesses/small-businesses-self-employed/intangibles

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