

"The Ins and Outs of Practice Ownership: Entry, Evolution & Exit Transition Strategies"

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Course: "The Ins and Outs of Practice Ownership: Entry, Evolution & Exit Transition Strategies"

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Sponsors: New Jersey Academy of General Dentistry
MileStone Bank

Presenters: Dr. Philip A. Cooper; David Gill

Dr. Cooper is a graduate of the University of Rochester (B.A.), University of Pennsylvania School of Dental Medicine (D.M.D.) and Rutgers University Graduate School of Management (M.B.A.). His clinical experience includes two years as dentist in the Navy stationed at the Marine Corps Recruit Depot at Parris Island, South Carolina and twelve years in private practice in New Jersey.

American Practice Consultants was founded in 1985 by Dr. Cooper to provide practice transition services to dentists in New Jersey and Eastern Pennsylvania. These services include practice brokerage, practice appraisals and assisting in developing successful partnership arrangements. Dr. Cooper has been providing these services on a full-time basis for the last twenty years and has been involved with hundreds of transactions.

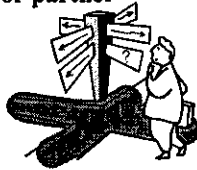
Dr. Cooper belongs to numerous professional organizations, has written articles on practice transitions on both the local and national level and has spoken to many dental groups on this subject. For more information, please visit www.ameriprac.com.

Methods of Transferring Ownership

- **Outright Sale**
- **Associate leading to sale**
- **Associate leading to partnership**
- **Sell and become Associate**
- **Delayed Sale**
- **Merger**
- **Sale of Charts**

Which Method is Best?

- **What is your Time Frame?**
- **Financial Situation (Time vs. \$)**
- **Already have an associate or partner**
- **GP vs. Specialist**
- **Difficult to sell practice**
- **Control**



Three Phases of a Transaction

- **Phase I - Finding / Negotiating**
- **Phase II - Documentation**
- **Phase III - Transition**

Preparing for the Transaction

- Practice Valuation
- Determining Method
- Team of Advisors
 - Accountant
 - Attorney
 - Consultant/Broker
- Updating
 - Equipment
 - Fees

Preparing for the Transaction

- Notifying Staff and Patients
- Do you have an associate?
 - Is he/she interested?
 - Is there a contract?
- Proposal / Packaging

Contracts and Legal Issues



Associates

- **Contract vs. No Contract**
- **Employee or Independent Contractor**
- **Compensation Arrangement**
- **Length and Renewal**
- **Notice time**
- **Restrictive Covenants**

Practice Sale

- **Agreement of Sale**
- **Lease**
- **Employment Contract for Seller**
- **Bill of Sale**
- **Financing Documents**
- **Corporate Resolution**

Agreement of Sale

- **Spells out all key points of transaction**
- **Exhibits**
- **Similar but never exactly the same**
- **Seller's attorney usually prepares**
- **A lot of going back and forth**

Partnerships

- A lot more documentation since there are many more issues to deal with.
- Shareholder/Partnership/Operating Agreement
- Stock Purchase and Sale Agreements
- Employment Contracts
- Plus all the other documents in a sale

Partnerships

- Who prepares the documents?
- How long does it take?
- The buy-out

The Transition

- Depends on type of transaction
- Partnership – Indefinite
- Selling: Staying as an associate
 - Can last months to years
 - Days/Hours/Compensation/Benefits
- Selling/Not staying
 - How long?
 - Seller's functions
 - Spouse is an employee

The Transition

- Notifying Staff
- Notifying Patients
- Accounts Receivable
- Advice to Buyers: Do not rock the boat!

Practice Valuation

- Valuation and Appraisal are synonymous
- Types of Value
 - Book
 - Replacement
 - Fair Market

Fair Market Value

The price for which property would change hands between a *willing buyer* and a *willing seller*, neither being under any *compulsion* to buy or sell, and both having *reasonable knowledge* of the relevant facts.

Principles of Appraising

- **Principle of Alternatives:** In any contemplated transaction, each party has alternatives to consummating the transaction.
- **Principle of Future Benefits:** Economic value reflects anticipated future benefits.
- **Principle of Substitution:** The value of a thing tends to be determined by the cost of acquiring an equally desirable substitute.

Rules of Thumb

MMAM

Rules of Thumb

HCSIIBI

Methods of Valuation

- **Summation of Assets**
- **Net Revenue Multiplier**
- **Gross Revenue Multiplier**
- **Capitalization of Earnings**
- **Excess Earnings**
- **Discounted Cash Flow**
- **Market Comparisons**

Appraisals Should Reflect

- **Cash Flows – especially profit**
- **Tangible Assets**
- **Relevant Practice Factors**

Tangible vs. Intangible

- **Tangible Assets**
 - **Equipment**
 - **Supplies**
 - **Instruments**
 - **Furniture**

Tangible vs. Intangible

- **Intangible is generally referred to as Goodwill.**
- **Intangible can be subdivided into not only Goodwill but Patient Records and Restrictive Covenant as well.**

Goodwill

- **The expectation of future profit under the ownership of someone other than the present owner. It is comprised of those elements of a business that cause customers to return.**
- **The value of a business over and above the value of the tangible assets.**
- **In most dental practice, is the majority of the value.**

Cash Flows

- **Start with the Net Income and adjust back all items which are either part of the owner's profit or not normal operating expenses.**
- **The objective is to arrive at the projected profit of a buyer which can be referred to as the "Adjusted Profit".**

Adjusted Profit

- Net Income
- Officer Salary
- Pension/Profit Sharing
- Insurance – Medical, Auto, Life, Disability
- Automobile
- Rent
- Travel/Meals/Entertainment
- Depreciation
- Interest
- One time charges
- Any other discretionary uses of the cash flow

Determining Adjusted Profit

Gross	\$800,000	
Overhead	(550,000)	
Net Income	250,000	(Officer Salary)
Add back:		
Pension	40,000	
Medical	15,000	
Depreciation	10,000	
Auto	5,000	
Adjusted Profit	\$320,000	

Summation of Assets

- Practice Value = Value of Intangibles + Value of Tangibles
- Intangible (Goodwill) Value is typically the Adjusted Profit times a Factor.
- That Factor can range between a little less than 1.0 to 1.9. Most typical range is 1.2 to 1.6.
- Value of Factor is determined by Relevant Practice Characteristics.

Relevant Practice Characteristics

- The information that buyers typically consider in the decision making process of whether or not to purchase a particular practice.
- If they do decide to purchase, this information will be used to help determine how much (or little) they are willing to pay.

Relevant Practice Characteristics

- Location
- Type of Practice
- History
- Staffing
- Number of Patients
- Participation with Plans
- Hours
- Fee Structure
- Equipment
- Facility
- And Many More

Example

Adjusted Profit	\$320,000
Times Factor	<u>x 1.5</u>
Goodwill	480,000
Plus Tangible	<u>+ 60,000</u>
Practice Value	\$540,000

Valuing Tangible Assets

- Equipment -

- **Types of Value**
 - Book
 - Replacement
 - Market Value
- **Supplier**
- **Depreciation Schedule**
- **Life Expectancy: 12 to 15 years with a 10% residual value.**

Valuing Tangible Assets

- Other -

- **Supplies:**
 - Three months average:
 $\$40,000 \times .25 = \$10,000$
- **Instruments:**
 - Percent of Gross: 1.0% to 1.5%
- **Furniture**
- **Real Estate**
- **Leasehold Improvements**

Income Approaches

- **Capitalization of Earnings**
- **Discounted Cash Flow**
- **Excess Earnings**

Capitalization of Earnings

$$\text{Price} = \text{Earnings} / \text{Rate of Return}$$

- **Earnings:** Owner's Profit less cost of professional labor.
- **Rate of Return:** In this case, is called the Capitalization Rate. It is the return an investor anticipates for investing in a particular asset, which in this case would be a business.

Example

Gross	\$800,000
Overhead	480,000 (60%)
Profit	320,000 (40%)

Example

Hygiene 20%: $800,000 \times .2 = 160,000$
Dr Production: $800,000 - 160,000 = 640,000$
Replacement Dr: $640,000 \times .35 = 224,000$
Earnings: $320,000 - 224,000 = 96,000$

Example

Capitalization Rate

Safe	.04
Risk	.03
Liquidity	.10
Management:	<u>.03</u>
Total:	.20

Example

$$\begin{aligned} \text{Price} &= \text{Earnings} / \text{Rate of Return} \\ &= 96,000 / .20 \\ &= \$480,000 \end{aligned}$$

Does it make Economic Sense?

Is there sufficient cash flow to meet the overhead, debt service and to pay the new owner a reasonable return?

Does it make Economic Sense?

Price: (average)	\$510,000
Working Capital	<u>35,000</u>
Amount Financed	545,000
Years	7
Interest Rate	6.75
Monthly Payment	8,159
Yearly Payment	\$97,909

Does it make Economic Sense?

Gross	\$800,000
Less: Overhead	(480,000)
Debt Service	<u>(97,909)</u>
Buyer's Profit	\$222,091

Tax Issues

- Sale of a practice is a taxable event
- Seller pays taxes; Buyer does not
- Seller's goal is to minimize taxes
- Buyer's goal is to be able to write-off the price and to accelerate the write-offs

Allocation of Sales Price

The price is separated into various asset categories:

- Equipment
- Supplies
- Goodwill
- Patient Records
- Restrictive Covenant
- Stock

Two Types of Taxes

- Ordinary Income (OI)
- Capital Gains (CG)
- Currently, at the federal level, CG are maximum of 15%.
- There can be a significantly lower tax obligation for the Seller if more of the price is allocated towards CG assets.

Tax Treatment

<u>Asset</u>	<u>Seller</u>	<u>Buyer</u>
Equipment	Below basis none; basis to cost OI; over cost CG	Depreciable over 5-7 yrs. \$250K in 2010
Supplies	OI	Deductible
Goodwill	CG	Depreciable over 15 yrs.
Patient Records	CG	Depreciable over 15 yrs.
Restrictive Covenant	OI	Depreciable over 15 yrs.
Stock	CG	No Write-off

Other: Leasehold Improvements, Accounts Receivable

Tax Issues

- **Paying Tax on Profit, not the sales price**
- **Installment Sale: Depreciation Recapture**
- **C Corp – Double Taxation Issue**
 - Taxed first at corporate level (35%)
 - Then at personal level (your rate that year)
 - Get around this by using “Personal Goodwill” and keeping outside of corp.
 - IRS tax court cases uphold this concept (Norwalk vs. the Commissioner; Martin Ice Cream Case)
- **IRS Form 8594**

NJ and You!

- **State requires part of price be put in escrow. Original concept was to make sure no Bulk Sales Tax was owed by Seller**
- **Has “Evolved”**
- **NJ Requires: “Notification of Sale, Transfer or Assignment In Bulk”**
- **Buyer’s attorney requests but Seller must sign**
- **Buyer Protection**
- **Sent to state at least ten days before settlement and has to have the signed Agreement of Sale**
- **State reviews and determines an escrow amount which the Buyer’s attorney holds**
- **Now state wants an amount to cover any and all potential taxes owed by Seller**

NJ and You!

- **Amount used to be about 1% of the price; now is 5% to 10%**
- **Once State is informed of closing, they will send the parties an “Asset Transfer Tax Declaration” which the Seller’s accountant is to complete. This is to estimate the overall taxes (including the income) the seller will owe the State from the sale.**
- **If State agrees, they will instruct the Buyer’s attorney to pay the State that amount. Once received, they will issue a clearance letter for the balance of the escrow to be released to the Seller.**
- **Bottom Line: Seller must pay the estimated NJ Income Tax from the sale of the practice during the year of the sale, not the following April 15th!**

Partnerships – Key Ingredients

- **What is being Sold**
- **Price**
- **Terms**
- **Income Splitting**

Partnerships – Key Ingredients

- **Income Splitting Methods:**
 - **Equal**
 - **Production (or Collection)**
 - **Allocation of Expenses**
 - **Part by Production / Part by Ownership %**
- **Must Define Profit**

Partnerships – Key Ingredients

Other Issues:

- **Management**
- **Five Year Plan**
- **Buy-Out Methodology**
 - Price**
 - Terms**
 - Who is going to buy?**

Topics: Agreement of Sale

Intro

Assets being sold

Assets to be retained by seller

Purchase Price

Manner of Payment

Allocation

Time and Place of Closing

Documentation

Warranties and Reps of Seller

Warranties and Reps of Buyer

Restrictive Covenant

Practice Records

Transition

Accounts Receivable

Prepays

Inspection

Broker

Patient Letter

Liability

Indemnification

Telephone Number

Financing Contingency

Rework

Lease

Fire or Casualty

Expenses of Transaction

Governing Law

Successors and Assigns

Incorporation of Buyer

Severability

Notices

Entire Agreement

Failure to Settle

“Independent Contractor”

Employee or independent contractor for tax purposes?

Are you classifying the people performing services for your business as independent contractors for IRS tax purposes? Is it possible that they might really be employees for IRS tax purposes?

How these workers are classified for IRS tax purposes has major tax consequences because employees and independent contractors are treated differently for IRS tax purposes. Potential disasters await your business if the worker is classified for tax purposes improperly. Improper classification for tax purposes can cause problems that could financially destroy your business. Business owners must withhold income tax on employees' wages, and must pay Social Security tax (FICA) as well as withhold the employees' portion of the FICA. They also are responsible for unemployment tax (FUTA) and must provide the employee with a Form W-2, "Wage and Tax Statement," showing the amount of wages and tax withheld for the year. Payments to an independent contractor that total \$600 or more for the year must be reported by the business owner on Form 1099-MISC, "Miscellaneous Income," and filed with the IRS. A copy also must be given to the independent contractor.

The key factor which determines whether a worker is an independent contractor is who has the right to control the worker as to how work is accomplished?

Government entities, interested or damaged third parties, and perhaps the worker himself will often challenge the classification as independent contractor for a variety of reasons.

Enormous tax problems can result from improper classification for IRS tax purposes.

The IRS has developed twenty common law factors which are used on a case by case basis to determine whether a worker is an independent contractor or an employee for IRA tax purposes. Independent contractors do not have to satisfy all of the twenty common law factors. It is best to think of the factors as weights on a balance scale.

The twenty common law factors of a perfect independent contractor relationship are:

- *No Instructions.* Independent contractors are not required to follow, nor are they furnished with, instructions to accomplish a job.
- *No Training.* Independent contractors typically do not receive training by the hiring firm. They use their own methods to accomplish the work.
- *Others can be hired.* Independent contractors are hired to provide a result and usually have the right to hire others to do the actual work.
- *Independent contractor's work not essential.* A company's success or continuation should not depend on the service of outside independent contractors. An example violating this would be a law firm which called their lawyers independent contractors.
- *No time clock.* Independent contractors set their own work hours.
- *No permanent relationship.* Usually independent contractors don't have a continuing relationship with a hiring company. The relationship can be frequent, but it must be at irregular intervals, on call, or whenever work is available.

- ***Independent contractors control their own workers.*** Independent contractors shouldn't hire, supervise, or pay assistants at the direction of the hiring company. If assistants are hired, it should be at the independent contractor's sole discretion.
- ***Other jobs.*** Independent contractors should have enough time available to pursue other gainful work.
- ***Location.*** Independent contractors control where they work. If they work on the premises of the hiring company, it is not under that company's direction or supervision.
- ***Order of work.*** Independent contractors determine the order and sequence in which they will perform their work.
- ***No interim reports.*** Independent contractors are hired for the final result only. They should not be asked for progress or interim reports.
- ***No hourly pay.*** Independent contractors are paid by the job, not by time. Payment by the job can include periodic payment based on a percentage of job completed. Payment can be based on the number of hours needed to do the job times a fixed hourly rate. Payment method should be determined before the job commences.
- ***Multiple Firms.*** Independent contractors often work for more than one firm at a time.
- ***Business expenses.*** Independent contractors are generally responsible for their own business expenses.
- ***Own tools.*** Independent contractors usually furnish their own tools. Some hiring firms have leased equipment to the independent contractors so that they could show the independent contractor had their own tools and an investment in their business. This strategy won't work if the lease is for a nominal amount or can be voided by the hiring firm at will. The lease must be equivalent to what an independent business person could have obtained in the open market.
- ***Significant investment.*** Independent contractors should be able to perform their services without the hiring company's facilities (equipment, office furniture, machinery, etc.). The independent contractor's investment in his trade must be real, essential, and adequate.
- ***Services available to the public.*** Independent contractors make their services available to the general public by one or more of the following:
 - 1) having an office and assistants;
 - 2) having business signs;
 - 3) having a business license;
 - 4) listing their services in a business directory; or
 - 5) advertising their services.

"The Independent Contractor"

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•*Profit or Loss possibilities.* Independent contractors should be able to make a profit or a loss. Employees can't suffer a loss. Five circumstances show that a profit or loss is possible:

- 1) the independent contractor hires, directs, and pays assistants;
- 2) the independent contractor has his own office, equipment, materials, or facilities;
- 3) the independent contractor has continuing and recurring liabilities;
- 4) the independent contractor has agreed to perform specific jobs for prices agreed upon in advance; and
- 5) the independent contractor's services affect his own business reputation.

•*Can't be fired.* Independent contractors can't be fired so long as they produce a result which meets the contract specifications.

•*No compensation if the job isn't done.* Independent contractors are responsible for the satisfactory completion of a job or they may be legally obligated to compensate the hiring firm for failure to complete.

There is also a federal "safe harbor" rule which can exempt certain workers from the twenty common law factors. To be exempt from the twenty common law factors, a hiring firm must:

- have consistently treated the worker and similar workers as independent contractors;
- have filed all the required forms; and
- have had some reasonable basis for treating the worker as an independent contractor because there were similar rulings or court cases, or because it was an industry-wide practice or because prior tax auditors had never questioned the practices.

If a worker clearly is an independent contractor, a complete agreement to that effect is useful and recommended; however, any agreement, no matter how well drafted and explained to each party and signed, will not change the results if a person is held to be an employee under the facts and circumstances.

The laws surrounding the employee versus independent contractor issues are extremely complex and you should consult with a tax attorney on these issues.

Improperly classified employees can cause business owners to end up with hefty penalties for non payment of employment tax. Those who need help deciding if their workers are employees or independent contractors can fill out Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Tax and Income Tax Withholding. The IRS will tell them if their workers are employees or independent contractors.

OVERHEAD PERCENTAGES

(as a percent of the gross)

Average	Acceptable Range	
22.0	20 - 25	EMPLOYEE WAGES (not including dentists)
8.0	7 - 9	LABORATORY
6.0	5 - 7	SUPPLIES
5.0	4 - 6	RENT
3.0		PAYROLL TAXES
3.0		PENSION/PROFIT SHARING
2.0		UTILITIES
2.0		DEPRECIATION
2.0		INSURANCE
2.0		OFFICE EXPENSE
1.0		ACCOUNTING & LEGAL
1.0		INTEREST-OTHER
1.0		ADVERTISING
1.0		MISCELLANEOUS
1.0		EMPLOYEE BENEFITS
0.5		REPAIRS
0.5		CONTINUING EDUCATION
0.5		TRAVEL & ENTERTAINMENT
0.5		AUTOMOBILE
0.5		DUES, PUBL., MEETINGS
0.5		OTHER
0.2		LAUNDRY AND CLEANING
0.2		INTEREST-MORTGAGE
0.2		POSTAGE
0.1		UNIFORMS
0.1		BANK SERVICE CHARGES
0.1		LICENSES

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EDUCATIONAL BACKGROUND

- 1982 – 1984 RUTGERS UNIVERSITY, Newark, New Jersey
Graduate School of Management
Executive Management Training Program
M.B.A.
- 1972 – 1976 UNIVERSITY OF PENNSYLVANIA, Philadelphia, PA
School of Dental Medicine
D.M.D.
- 1966 - 1970 UNIVERSITY OF ROCHESTER, Rochester, New York
B.A.

PROFESSIONAL EXPERIENCE

- 1985 – Present AMERICAN PRACTICE CONSULTANTS, INC.
Moorestown, New Jersey
A firm I founded to provide assistance to dentists in the following areas:
Practice Sales, Practice Appraisals and Partnership Arrangements. I have
worked extensively with hundreds of dentists in all types of practice
transfers and have done so on a full-time basis since 1990. I am recognized
as a court approved expert witness in practice valuation. In addition, I have
consulted with dentists in evaluating associateship arrangements and
practice start-ups.
- 1978 – 1990 PRIVATE PRACTICE OF DENTISTRY
Various locations in New Jersey and Pennsylvania
Includes working in a number of small and large offices for other dentists,
as well as two practices of my own.
- 1976 – 1978 U.S. NAVY DENTAL CORP
Parris Island, South Carolina
Staff Dentist
- 1970 – 1972 MORGAN GUARANTY TRUST COMPANY
New York, New York
Credit Analyst

MEMBERSHIPS

American Society of Appraisers
International Business Brokers Association
Institute of Business Appraisers
ADS (American Dental Sales)
Practice Valuation Study Group
American Dental Association
New Jersey Dental Association
Southern Dental Society
Rotary International

**SPEAKING
ENGAGEMENTS**

I have spoken to numerous groups concerning practice transitions and valuation including dental schools, dental societies, hospital staffs, dental conventions (New Jersey, New York, Liberty), residency programs and many other dentists through seminars that my firm has sponsored.

ARTICLES

“Restrictive Covenants”, Spring 1988, Journal of the New Jersey Academy of General Dentistry.

“Common Questions When Selling A Practice”, 1990 and 1991 in various local dental and medical society journals.

“Partnerships: The Key Ingredients”, November 1993, Dental Economics.

“Methods of Transferring Practice Ownership”, 1994, in various local dental journals.

“Update on Practice Valuation”, 1996, in various local dental journals.

“Practice Transition Update”, 2003, in various local dental journals.

“Exit Strategies”, 2008, in various local and state dental journals.

“The Three Phases of Practice Transactions”, 2010, Journal of the New Jersey Academy of General Dentistry.

**CONTINUING
EDUCATION**

I have taken numerous courses in all areas relating to the sale and valuation of professional practices and small businesses. Sponsors include national organizations such as the American Society of Appraisers, Institute of Business Appraisers, International Business Brokers Association and the Practice Valuation Study Group.