business practice

Information on the business management of a dental office.

OD Practice Management

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Incorporation

How Does it Affect the Purchase, Sale and Value of a Practice?

PART 1

Introduction

Buying or selling a dental practice carries numerous tax implications. For the **seller**, the most significant is the potential tax savings achieved via professional incorporation. This mechanism can potentially shelter up to $750,000 from income and/or capital gains taxes — an opportunity few would want to miss! For the **buyer**, this tax shelter is less favourable, as he or she cannot write-off some or all of the purchased assets. This article will review the impact of incorporation on the purchase, sale and fair market value of a dental practice.

The Seller

It is prudent for a seller to legitimately minimize the taxes payable on the sale of a dental practice. Incorporation allows for that to occur, because no taxes are payable on the first $500,000 of share sale proceeds — and this is likely to increase to $750,000 once the recent federal budget becomes law. The costs of incorporating are modest when compared with the substantial tax savings the seller may achieve — typically 15 to 25 percent of the final sale price. For example, if a practice sells for $500,000, an incorporated dentist, by selling shares rather than assets, could save up to $125,000 in income taxes. Thus, today's seller is highly motivated to offer a practice for sale as a corporation.

The Buyer

It is less favourable for the buyer to buy shares versus assets. Buyers seek to pay a fair price for the practice, while hoping to depreciate the assets over time and thus reduce taxable income. Unfortunately, the purchase of shares works against the buyer as he or she loses the future income tax shield: a buyer cannot write off most of the assets purchased in a share sale, resulting in higher income taxes each year thereafter.

However, when buying a corporation there are some benefits to the buyer. He or she does not have to pay PST on the equipment or GST on the leaseholds — a savings of roughly $15,000 to $25,000 in sales taxes for a typical practice sale. As well, most accountants advise that a buyer should form a new corporation when purchasing the seller's corporation, thus allowing for the debt to be paid in corporate after-tax dollars, versus personal after-tax dollars. In short this means the purchaser services the debt in a much more tax-efficient manner.

Fair Market Value

There are many schools of thought as to which is the best method to appraise a practice. I note the growing number of companies offering appraisals and have examined the various methods employed by each. As an appraiser myself, I am biased to suggest that one method is superior to another. However, the major Canadian banks have confirmed their preferred appraisal method, and it's unanimous: the direct comparison approach. This means comparing one practice to others that are similar and that have recently sold on the open market. There are hundreds of variables to compare, but the most common include:

- **type** (preventive, specialty, restorative)
- **size** (both in terms of equipment inventory and square footage)
- **patient volume indicators** (gross and net incomes), and most importantly
- **location**

When a practice appraiser has access to open market sales data, the direct comparison method usually produces the most accurate value. As well, it is easily understood by the market place at large and buyers can easily connect with the rationale as to why one practice may be more valuable than another when studying the variables used for comparison.

Alternative Appraisal Methods – Incorporation

Another appraisal method is to examine the practice as an investment only, not as a career choice. In this approach, the appraiser applies a formula whereby the owner is treated as a notional associate in order to determine the return on the investment (ROI). The appraiser deducts true operating expenses of the practice (and adjusts for non-practice expenses), associate earnings (typically 40 percent of dentist production) and income taxes, from gross income. The result of this equation is known as the excess earnings, or the after-tax profit the practice may generate after the owner had been paid a reasonable "salary". These earnings are then divided by a selected capitalization rate to determine the value of the practice.

The concept of Fair Market Value implies that value should be determined by a market-based approach — not a taxation based approach.

There are several debatable elements of this method, the most notable being the appraiser's choice of the income tax rate — should it be personal or corporate? Either tax rate can be used, but the corporate tax rate (being about one-half of the personal rate) results in substantially higher excess earnings, which then produces a substantially higher value for the practice (good news if you're an owner).

Personal Versus Corporate?

Which tax rate should the appraiser select and why? The answer, from a highly reputable and experienced accountant, is that the choice of a tax rate is highly subjective and is unreliable for determining fair market value. One accountant pondered: "Just because a dentist can incorporate, does that mean that he should pay more for a practice than one who does not incorporate?" Another said, "This shouldn't impact the fair market value of the practice, but can make a purchase more feasible for some."

I surveyed other accountants for their opinion on this highly controversial topic. The commonly held belief was that the use of differing tax rates in an appraisal should not be a guide to determine fair market value. And further, a brief survey of a wider circle of dental advisors (bankers, consultants & lawyers) suggested that this emerging trend of valuation is not credible. As a business owner, I would prefer that my business be appraised using this method, but as a realist, I know that my business is only worth what the market will bear.

Conclusion

The marketplace is very intelligent and well-informed. It watches the trends in values and also keeps an eye on the appraisers, myself included. In the present, over-heated market of the GTA, any attempt by appraisers to increase market values further is being closely examined. Those who study the market have already scrutinized our various methods many times, and any changes we make are immediately questioned and challenged. The marketplace says that the direct comparison method remains the only true, time-tested approach to determining the fair market value of a dental practice. OD

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NOTE: Readers are strongly advised to seek professional advice for incorporation and taxation matters.