

How To Buy an Incorporated Dental Practice

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Introduction

Dentists in a number of provinces have been able to incorporate their dental practices for some time. In these provinces, practitioners have tax savings that are not available to unincorporated practices. At the same time however, there are a number of additional complexities in the valuation and sale of an incorporated practice. The objective of this article is to provide an increased understanding of these complexities, as well as outline some standardized approaches for dealing with some issues that may arise when selling an incorporated practice.

Will I Be Buying Assets Or Shares?

In the sale of an incorporated practice there are two options - either the corporation sells assets to the purchaser or it sells shares of the corporation.

An asset sale from a corporation is very similar to that of an unincorporated practice and the conventional approach to valuation can normally be applied.

However, with the "enhanced capital gains exemption" (which has a limit of \$500,000 and applies when shares of a qualified small business corporation are sold) incorporated practices pay little or no income tax if shares are sold. For this reason, it is the experience of the authors that the majority of sales for incorporated practices, involve the sale of shares.

How Does a Share Sale Work?

A useful way to look at a corporation is illustrated in Fig. 1.

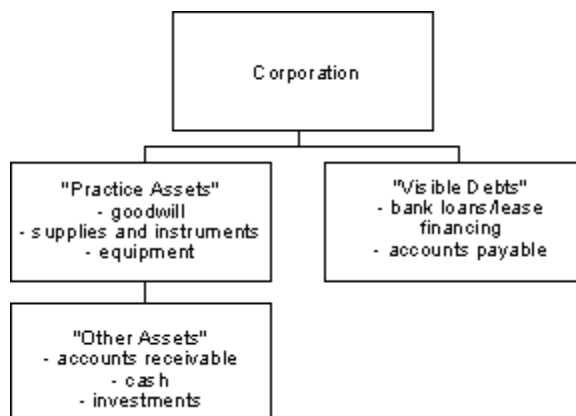


Fig. 1: Financial breakdown of a corporation

As illustrated, a corporation has two types of assets: practice and other assets. As well, there is the "visible" debt. Buying shares of a corporation means buying all the assets and debts.

Practice Assets

Practice assets are normally sold in the sale of unincorporated practice. The methodology for valuation of these assets has been established over many years and is generally well understood.

Other Assets

An important point to note is that when buying shares, accounts receivable are also purchased.

While the receivables will be open on the corporation's books for a certain amount of time, the "fair value" of the receivables should be assessed. In particular, two factors may decrease the book value of the receivables:

- 1) Some receivables will be uncollectible.
- 2) The administrative costs (staff time, postage, etc.) to be paid by the purchaser in order to collect and process the outstanding receivables.

Valuation of accounts receivable is tricky. Therefore, one approach might be for the purchaser to pay the vendor for receivables over time, as the money is actually collected.

In addition, a corporation may also have cash, investments and other assets at the time of sale. In most cases, these "redundant" assets are removed by the vendor before the sale. If not, the purchaser normally will not pay for these assets since, once they are purchased there is no tax consequence if removed from the corporation.

If redundant assets remain with the corporation at the time of sale, the purchaser's tax advisor should make a determination of after-tax value.

Visible Debts

When purchasing a corporation, in one sense, the new owner assumes responsibility for the corporation's debts. This *does not* mean that individuals owed money by the corporation can make claims against the purchaser personally. (Unless the purchaser has signed a "personal guarantee," which should be avoided whenever possible.) However, repayment of debts will diminish future withdrawals from the corporation.

For a purchaser, this normally means that the purchase price is reduced by the amount of the debt held by the corporation. Of course, this debt must be measured at the actual time of the sale. The corporation's last year-end financial statements are not reliable because debts fluctuate on a daily basis.

It is also customary for the purchaser to hold back a portion of the purchase price for several months, in case debts surface that were not identified at the time of sale.

Loss Of Future Write-Offs

Another impact of buying shares versus assets, is that the purchaser may be able to claim less depreciation in the future. Frequently, goodwill and equipment have a market value higher than the amount carried on a corporation's books. If the assets are bought directly, the assets go into the purchaser's books at market value and are subsequently depreciated from the amount.

However, when shares are purchased, the equipment has not changed hands. It is still owned by the corporation. Therefore, the future depreciation does not increase with the change in ownership. But, the depreciation over time can be considerable. Table I illustrates the rate of depreciation.

Table I: Illustration Of Depreciation Rate

Assumptions			
Market value of equipment		\$100,000	
Value on books of corporation		\$60,000	
Depreciation rate (half in year of purchase)		20%	
Future depreciation			
Year	Buy assets	Buy shares	Lots deduction for year
1	\$10,000.00	\$12,000.00	(\$2,000.00)
2	\$18,000.00	\$9,600.00	\$8,400.00
3	\$14,400.00	\$7,680.00	\$6,720.00
4	\$11,520.00	\$6,144.00	\$5,376.00
5	\$9,216.00	\$4,915.00	\$4,301.00
6	\$7,373.00	\$3,932.00	\$3,441.00
7	\$5,898.00	\$3,146.00	\$2,752.00
8	\$4,719.00	\$2,517.00	\$2,202.00
9	\$3,775.00	\$2,013.00	\$1,762.00
10	\$3,020.00	\$1,611.00	\$1,409.00

From this example, the purchaser loses tax deductions totaling \$34,363 on the equipment. When multiplied by the corporation's tax rate (usually 20 per cent), the difference is substantial.

A standard formula for evaluating the loss of this "tax shield" is to calculate the depreciation for seven years after the purchase of each depreciable asset. Take the "present value" of these amounts (in other words, discount them based on an assumed interest rate). The result is then multiplied by 35 per cent, representing the average of the corporate and personal income tax rates, to calculate the value of the lost tax shield that should be considered in the purchase price.

One caution should be added. If the corporation bought assets (particularly goodwill) from what Revenue Canada calls a "non-arms length party" (in other words, when the dentist sells his own goodwill to the corporation), the amount of eligible depreciation is often lower than what is shown on the company's books.

For example, assume a corporation has a goodwill on its books for \$80,000 and this goodwill was bought from the vendor with a book value of \$20,000 at the time of transfer to the corporation. In this case, the corporation's depreciation base (from which the lost tax shield is calculated) is \$20,000 not \$80,000. This difference is sometimes overlooked by accountants in the purchase of a corporation.

Summary

Fig. 2 summarizes the process for valuation of the shares of an incorporated practice.

Value of practice assets
less
Adjustment for uncollectibility/administration of accounts receivable
less
Discount to value of cash and investments (if any)
less
Amount of visible liabilities
less
Present value of lost "tax shield"
equals
Purchase price

Fig. 2: Summary Process For the Valuation Of the Shares Of a Practice Corporation

As is evident, the purchase and sale of an incorporated practice is more complicated than the purchase of an unincorporated practice. If costly mistakes are to be avoided, it is essential that both parties be assisted by knowledgeable advisors.

The material provided here is for information purposes only and should not be construed as advice for a specific set of circumstances. It is recommended that this information be provided to your financial advisor.

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