

PURCHASE OF A DENTAL PRACTICE

ASSET PURCHASE

An outright purchase of the assets of a Dental Practice is not a simple exercise. However it is much less complex than the purchase of shares.

It is important to have a knowledgeable valuator establish the value of the Fixed Assets of the practice and assign a value to the Goodwill. The vendor and purchaser negotiate a price to transfer these assets free and clear of any liabilities. This negotiation will be coloured by the tax implications to both parties.

The allocation of the purchase price between Fixed Assets and Goodwill will make a big difference to both the vendor and the purchaser. A higher value for Goodwill will give the vendor a lower Capital Gain, but also provide the purchaser with much lower tax deductions. A higher value for Fixed Assets will result in more tax deductions for the purchaser, but may result in Recaptured Depreciation to the vendor which will be taxed at full rates instead of half the tax rate.

Other assets and liabilities of the practice are generally not transferred to the purchaser.

- The vendor keeps his/her own bank account.
- The purchaser collects any payments on the Accounts receivable at the date of sale, but would not assume those Receivables. If any were not collectable, it does not affect the purchaser, and consequently does not affect the value paid for the practice.
- The vendor is responsible to pay off any debts incurred in the vendor's name. Unless there is a lien against the assets purchased, the purchaser is not concerned with the amount of any such debts as they are not legal debts of the purchaser. If any assets are pledged as collateral for the vendor's debt, the vendor agrees to discharge the security pledge prior to transferring the assets.
- Liabilities for acts prior to the purchase of the Assets do not affect the purchaser of the practice.

USING A PROFESSIONAL CORPORATION TO PURCHASE ASSETS

If a purchaser buys the Assets of a Dental Practice through a Professional Corporation, the future earnings of the Professional Corporation will be used to repay the debt required to purchase the practice. Since a Professional Corporation can keep 80% of its income (up to \$225,000 in 2003, \$250,000 in 2004) after tax, it will be in a position to repay the debt more rapidly than if the practice had been purchased in an unincorporated business which only will have 54% of its income to repay its debts.

For example, to pay off a \$500,000 purchase price, a dentist would have to earn a cumulative \$625,000 of before tax income through a corporation, whereas an unincorporated dentist must earn \$926,000 to have the same amount of after tax income to repay the debt.

From a practical point of view, this means that it will take almost 50% longer to repay the debt unless the owner is willing to substantially cut back on personal cash flow. If it takes longer to repay the debt, the interest cost will, of course, be higher.

SHARE PURCHASE

The purchase of the shares of a Professional Corporation is a very different and much more complex exercise which entails considerably greater risk to the purchaser than the outright purchase of Fixed Assets and Goodwill.

Shares of a Corporation represent the EQUITY of the Corporation, which means the difference between the Fair Market Value of ALL of the assets of the Corporation minus the total liabilities of the Corporation. The valuation of the Fixed Assets and the Goodwill of a Dental Practice is just the first step in the process of determining the value of the shares of the Professional Corporation.

Since a Corporation is a separate legal entity, the Corporation (not the owner) is liable for all its own debts and fully owns all the assets. In addition to supplier invoices payable, the Corporation's debts also include liability for Employer Deductions and Employer Health Tax with respect to the employees of the Corporation to the extent they may have been under-remitted in the past.

Consequently when SHARES of a Corporation are valued, the Fair Market Value of all of the assets must be determined and all liabilities of the Corporation must be identified and deducted from the value of the assets in determining the residual value of the shares.

ASSETS OF THE CORPORATION

The Corporation's bank accounts are assets of the corporation and continue to belong to the Corporation when it changes hands.

The Corporation continues to collect its Accounts Receivable. If any of the Receivables are not collectable the Corporation is the loser (and consequently the new owner). When valuing a Corporation's shares, careful attention will have to be paid to the collectability of the Receivables in determining the value of the shares. An agreement to purchase shares should include a Price Adjustment Clause that makes the vendor responsible for any significant difference in the realized value of the Receivables.

LIABILITIES OF THE CORPORATION

Since all debts of the Corporation will be paid by the corporation after the new owner acquires it, full disclosure of all debts in the name of the Corporation is critical. All outstanding debts to be paid by the new owner will reduce the value of the shares, since some of the assets being purchased will be used to pay those debts.

There could be hidden liabilities that are not immediately apparent to a purchaser. Since the Corporation employs the staff of the practice, the Corporation is responsible for any liabilities to those employees. If the employees have been long term members of the practice, the Corporation would be responsible for any severance liability in the event the new owner wishes to terminate an employee. Although the corporation may only have been in effect for a brief time, it will be liable

for all liabilities of the original owner of the practice to the employees. This would include liabilities for severance as well as potential constructive dismissal, sexual harassment claims, etc.

Other liabilities that become the concern of the new owner of shares of a Professional Corporation could include situations where the Corporation is sued by an individual who claims to have hurt themselves on the premises in the past. While professional malpractice liabilities reside with the licenced dentist, not the Professional Corporation, the Professional Corporation is responsible for all other potential liabilities.

Again, an agreement to purchase shares of a Professional Corporation would need to reflect assurances concerning such liabilities as well as an indemnity by the vendor if liabilities surface in the future related to the period prior to the purchase. This indemnity would need to cover both the liability itself and the legal costs related to defending the corporation from the claim.

AMOUNTS OWED TO THE FORMER SHAREHOLDER

In many cases, the practice assets were originally transferred into the Corporation by a Section 85 Rollover of the assets which permits an individual to transfer assets into a corporation without triggering income tax on accrued capital gains or recaptured depreciation.

The Corporation may still owe the current shareholder a promissory note for some of these assets. In this case, the value of the shares is reduced by the debt owed to the vendor shareholder. The purchase would have to inject cash into the acquired corporation and then the corporation would repay the loan to the vendor. The balance of the purchase price would be paid for the shares, resulting in a possible capital gain to the vendor.

In some cases, when assets were transferred into the Corporation by a Section 85 Rollover, the transferor acquired Redeemable Preferred shares for part of the transfer. These Redeemable Preferred shares often have a minimal 'paid up capital' (tax value) and a high redemption rate. At the time these shares are redeemed by the company, a deemed dividend is triggered for the difference between the redemption amount and the Paid Up Capital. This amount is similar to a debt of the Corporation and reduces the value of the Common shares of the Corporation.

TAX LIABILITES OF THE CORPORATION

When valuing the Shares of any Corporation, the valuator must take into account any accrued tax liabilities inherent in the corporation. For example if a corporation owns a building which has appreciated, or has been substantially depreciated over the years, there will be substantial Capital Gains and Recaptured Depreciation which will be taxed in the corporation's hands some day in the future when the building is sold. This future tax liability would need to be calculated and the present value of it taken into account, when determining the value of the shares.

Similarly, if there were a significant accrued Capital Gain on Goodwill in a Professional Corporation, the future income tax liability would need to be factored into the price of the shares.

Since the corporation is a continuing legal entity, any outstanding income tax liabilities of the corporation continue to exist after the change in ownership. In the event of an income tax audit, if there are additional income taxes owing related to expenses claimed inappropriately in the past or revenues not properly reported in the past, the new owner would have to pay the additional tax (including penalties and interest) resulting from a tax audit. Similarly if there is a GST audit that determines that GST should have been remitted in the past, the corporation is liable for the GST plus any interest and penalties.

If the Professional Corporation has paid its owner a salary in prior years, resulting in the total salary costs to the corporation exceeding \$400,000 per annum, it is important to ensure that the appropriate Employer Health Tax has been paid by the Corporation, since a subsequently discovered deficiency will be the Corporation's liability, not that of the vendor.

Similarly, if there was a deficiency in payment of sourced deductions or corporate income taxes, the government would look to the Corporation to meet its obligations, regardless of who owned the company at the time the obligations were incurred.

DISCOUNT FOR LACK OF TAX DEDUCTIONS

When purchasing Shares, the cost to the purchaser is much higher than it would be to purchase Assets. A purchase of Shares in a Professional Corporation is much like purchasing any share Investment. There are no deductions available to amortize any of the purchase price.

When purchasing shares, the buyer would expect the price to be discounted based on the difference in the tax treatment. This difference will vary significantly depending on the age of the assets and the relative mix of fixed assets vs. goodwill.

For example, the price of shares of a practice which has a large component of recently acquired fixed assets, and relatively low goodwill would need to be discounted more than the price of shares of a practice whose value was primarily based on the goodwill of the practice with relatively old equipment.

Lost depreciation if shares are purchased:		
Equipment	\$500,000	\$100,000
Goodwill	<u>\$100,000</u>	<u>\$500,000</u>
	<u>\$600,000</u>	<u>\$600,000</u>
Lost tax deductions over 10 years:	<u>\$439,602</u>	<u>\$322,126</u>

Consequently the amount that a practice will be discounted for the purchase of shares will depend on the mix of assets acquired and the magnitude of tax sheltering that is foregone.

DUE DILIGENCE

Consequently the valuation of the practice is just the first step in the valuation of the SHARES of a corporation. It is imperative to know the Fair Market Value of all of the assets of the Corporation and all of the debts including amounts owed to the Shareholder and the amount of any outstanding Redeemable Preferred Shares.

Since Corporations are more complex than unincorporated businesses, it is imperative that they have good accounting systems which fully reflect all assets and liabilities of the corporation. Purchasers would want to carefully review these accounting records for the past before purchasing the corporation.

A purchaser would also want to see a financial statement prepared by a Chartered Accountant who had performed a Review Engagement (as a minimum) as at a date fairly close to the date of purchase. In the case of a corporation, the purchaser may wish to have the statements audited up to the date of closing to increase the level of assurance on the completeness and accuracy of the final figures.

Financial Statements prepared with a Notice to Reader indicating that the accountant had not reviewed, audited or otherwise attempted to verify the accuracy or completeness of the information reported would **not** give a purchaser sufficient assurance that there would be no costly surprises acquired along with the shares of the corporation.

Financial Statements of a practice that will be or has been transferred into a Corporation will be useful only as a reference point in calculating the Goodwill value of the business. They will not provide a purchaser with sufficient information to determine the value of the shares of the company into which the business will be or has been transferred.

PURCHASE OF A PARTNERSHIP INTEREST

The usual way to bring in a new partner is for the new partner to contribute an amount into the partnership equal to the proportion of value they will have after the contribution. The existing partners then withdraw some or all of this contribution on a tax-free basis. Eventually when a partner completely withdraws from the partnership, they will be deemed to have disposed of their partnership interest. If at that time, their partnership capital account is negative, they will have a capital gain equal to that negative amount.

The new partner has purchased an equity position, meaning that they have acquired a share in all of the assets and liabilities of the partnership. Consequently when valuing a partnership interest, the accountant must start from the Fair Market Values established in the Valuation for the Fixed Assets and Goodwill and add to that the value of other assets of the partnership. This will include ensuring that appropriate allowances for doubtful accounts have been reflected in the purchase price and that all liabilities of the partnership have been deducted from the purchase price. Again it will be important that the agreement allows for any adjustments to the purchase price based on Financial Statements up to the date of closing prepared by a Chartered Accountant performing a Review Engagement. While a Review Engagement will not necessarily reveal all undisclosed liabilities or overvaluations of assets, there will be a greater level of analysis, comparison of enquiry than would be done for a Compilation Engagement.

After the new partner has contributed his new capital, the assets of the partnership have not changed in value. Consequently the amounts of depreciation and amortization claimed by the partnership will continue to be based on the depreciated values before the buy-in not the fair market values reflected in the purchase price.

Consequently the purchaser of a partnership interest is in a similar position to a purchaser of shares, having fewer tax deductions available than if the assets had been purchased outright, and having to ensure that all liabilities have been disclosed and reflected in the value of the partnership interest.

Liabilities accruing prior to becoming a partner will be shared with the new partner unless there is something in the partnership agreement to require adjustment of such items against the partners in place at the time the liability occurred.

CONCLUSION

A lawyer's input is invaluable when drafting an Agreement To Purchase in order to ensure that all significant issues are covered. Since the structure of the vendor and purchaser impact on the way an offer will be drafted the above ideas will form a framework for discussion in this complex process.