

## Tax Efficient Practice Sales

By Dr. Gary L. Ackerman

The sale of a veterinary practice is uncharted territory for many veterinarians, and help in the form of professional advisors like accountants, attorneys, appraisers, financial planners, practice brokers, lenders, and realtors is necessary. Many owners also have interesting opinions as to the value of their practice, not based upon material facts and profitability. The NCVEI Profitability estimator ([www.ncvei.org](http://www.ncvei.org)) is a very good rough calculator of practice profitability after normalization of expenses, as is the No-Lo Practice brochure from VetPartners at [www.VetPartners.org](http://www.VetPartners.org). Buyers, especially today, will not pay for a practice's potential, just actual historical results and profits.

Once an initial value is arrived at, the estimated tax bill associated with a practice sale usually is a surprise, and many times is enough to make many potential sellers want to continue working (or never sell). The sale of a practice is a haven for tax efficiency, because numerous tax deferral methods exist. One must first understand how practices are sold and what the tax impact of the sales are to get an understanding of tax mitigation techniques.

### Practice Sale Tax Deferral Methods

Practice sales are typically either asset sales or entity (stock or LLC interests) sales. Most entity sales are transfers of partial entity interests or stock to a partner as part of a buy-in or phased purchase (usually by associates). Asset sales make up the majority of sales of practices. These include sales of fixed assets (usually equipment), sales of intangible items (typically goodwill), inventory, and possibly employment or non-competition contracts to assist in the transfer of goodwill.

Taxes due include:

- Depreciation Recapture Income Tax. This tax is at *ordinary income tax rates* on gains related to the equipment being sold, after depreciation, and is due the year of the sale.
- Capital Gains Tax. This is applicable to gain in practice value or entity interest value above initial cost basis
- Alternative Minimum Tax (AMT). AMT may be applicable at a practice sale due to increase in income for that tax year, and may be mitigated by tax deferral techniques. Please do an AMT analysis with any proposed sale.
- Ordinary Income Tax. Items taxed at ordinary income tax rates include most employment, or non-competition agreements, and inventory.

The traditional method of tax deferral for many years has been the installment sale. Other methods include Deferred Sales Trusts and 721 Exchanges. An installment sale is a sale with a gain where some of the payment is received after the year of the sale. Installment sales are often a necessary evil in practice sales, as some owner financing may be required by the lender to complete the transaction, and it is usually subordinated to bank debt, and therefore entails more credit risk. A 721 Exchange may be

utilized for contribution of property to an entity in exchange for entity interests, and the primary use is in practice mergers, or buyouts where the contributor locks in a future buyer (the parent entity).

Deferred Sales Trusts (DSTs) are an installment sale through a trust to defer current taxation. In a DST, assets are transferred to an independent trust in exchange for an installment note, and the trust then sells the assets to the end buyer. Taxes on the sale will be due as the seller receives principal payments on the note, which may be interest-only for longer tax deferral. The assets are segregated in an independent trust at national financial custodians. The interest rate on the installment obligation and investments are determined by the investment objectives and risk tolerance of the seller. The trust may hold other income producing assets (installment note from the buyer, annuities to mitigate investment and credit risk), and a credit line may be available to qualified borrowers for access to funds without a tax cost.

An example of a typical practice sale helps to illustrate the effects of tax deferral. In this hypothetical example, the majority of the value is goodwill, with 25% being equipment, inventory, and non-compete agreements. The appropriate federal tax rate is applied plus a state tax rate of 6%.

## Taxable Sale

Practice Value (PV)	\$1,600,000
Cost Basis	\$100,000
Total gain (PV – Cost Basis)	\$1,500,000
Tax due on gain	\$378,000
<b>Total Net Proceeds</b>	<b>\$1,222,000</b>
<b>Annual Income on Net Proceeds,</b> <b>\$1,222,000 invested @ 7%</b>	<b>\$85,540</b>

## Tax Deferral

Practice Value (PV)	\$1,600,000
Sent to DST	\$1,200,000
Tax due	\$126,000
Cash Proceeds	\$274,000
Taxes deferred	\$252,000
<b>Total Net Proceeds</b>	<b>\$1,474,000</b>
<b>Annual Income on Net Proceeds,</b> <b>\$2,674,000, invested @ 7%</b>	<b>\$103,180</b>

As a comparison, tax deferral ends up with 20.26% more assets (\$1.22M versus \$1.47M). Carried forward to income production from the assets (the goal of most practice sellers), it results in 20% greater income from the assets (\$103,180 versus \$85,540). Tax mitigation techniques can generate 15-30% more assets in and income production from a portfolio, depending upon the tax status of the sale and the state tax rate (higher state tax rates equals more tax benefits).

As a final thought on practice sales, there are many different seller needs and desires. I have touched on ways to preserve assets and possibly generate more income. Many sellers wish for cash proceeds from a practice sale, but the dilemma is transactional cash comes with a tax cost. Sale and tax planning may also help in estate, gifting, long term care, liquidity, or other family needs, which can be obtained with less tax cost. Although required, it is beyond the scope of this article to discuss appropriate investment and personal planning after a sale.

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