Tax Efficient Practice Sales

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The sale of a veterinary practice is in many circumstances the culmination of a long career, and may be the fork in the road leading to retirement, alternative careers, partnership, or a slower pace. It is commonly a transaction which generates much thought, consternation, indecision, education, questions, and concerns. The process 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.

A practice seller should set sale and retirement goals years in advance, as a practice sale may be the biggest asset sale of their lifetime. If properly planned, outside investments will be funded, and a practice buyer will be in waiting. Practice sellers frequently have psychological attachment to their former practice or real estate, but it should be treated primarily as an investment transaction. 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) is a very good rough calculator of practice profitability after normalization of expenses (required in order to do a practice valuation). Some practices may even have no value due to lower profitability, and a good way to gauge your practice situation is the No-Lo Practice brochure from VetPartners at 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, both the valuation and an estimated tax bill associated with the practice sale may be a surprise, and may be enough to make many potential sellers want to continue working or never sell. Many times the typical response is something to the effect of "I thought it was worth a year's gross", "How can they take so much" or "I worked so long to create this, only to give THAT MUCH to the government?" Many doctors recently have elected to defer the sales of their practices due to reduced valuations in the current economic conditions, or reduced valuations of other assets which may fund retirement. The sale of a practice is a haven for tax efficiency, because numerous tax deferral methods exist, which may contribute positively to a seller's future income or total assets. Please notice that I did not say tax elimination, as most methods which will be discussed defer the taxes to some point down the road (rather than eliminating them). One must first understand how practices are sold and what the tax impact of a sale is in order to get an understanding of tax mitigation techniques.

Practice Sale Tax Deferral Methods

Practice and real estate sales are typically either asset sales or entity (stock or LLC interests) sales. Most entity sales are transfers of partial entity interest or stock to a partner as part of a buy-in or phased purchase (usually by associates). Taxation of gains related to entity sales is solely at capital gains rates (likely 20% Federal + applicable state tax), which is beneficial to the seller but allows for reduced tax benefits to the buyer (less depreciation and possibly limited write-off of investment interest).

Asset sales make up the majority of the sales of practices and real estate. These include sales of fixed assets (usually equipment or real estate), inventory, intangible items (typically goodwill) and possibly an employment contract or covenant not to compete to assist in the transfer of practice goodwill.

Taxes due on the sale of a practice include:

- Depreciation Recapture Income Tax. This is an asset sale tax at *ordinary income tax rates* on gains on the equipment being sold. Please remember this is the gain above your equipment cost *after depreciation,* making the majority of the equipment sale price fully taxable (as most practices have depreciated the majority of the equipment cost). This tax is due the year of the sale and is the main tax which cannot be deferred regardless of the tax deferral method employed.

- Depreciation Recapture Tax. Real estate depreciation tax at a 25% Federal tax rate (+ applicable state rate).
- Capital Gains Tax. This tax is typically applicable to gain in practice or real estate value above initial cost basis plus any improvements, or the sale of an entity interest, at a tax rate of 15-20% of the gain.
- Alternative Minimum Tax (AMT). The net effect of the AMT could be an effective capital gains rate of 1%-3% higher. Please do an AMT analysis with any proposed sale.
- Ordinary Income Tax. Items taxed at ordinary income tax rates include most employment, consulting or non-competition agreements, plus inventory.
- Shadow Taxes . At higher levels of adjusted gross income (AGI), most deductions and exemptions phase-out, causing an effective tax rate which is higher the year of the sale.

The traditional method of tax deferral for many years has been the installment sale. Other methods include 1031 Exchanges (primarily real estate), Trust/Family LLC Installment Sales, 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 sale income typically consists of 3 parts- interest income, return of basis in the property, and gain on the sale (both depreciation recapture and capital gain). Installment sales are often a necessary evil in practice sales, as practice financing is challenging and installment obligations may be required by the lender to complete the transaction. Installment notes to buyers in practice sales are typically subordinated to bank debt, and therefore entail more credit risk to the seller.

IRC Section 1031 Exchanges are used for real estate tax deferral by selling an investment property and exchanging into another investment property. Requirements of a 1031 exchange include:

- Properties must be exchanged for like-kind properties. Like-Kind definition is very broad and includes most property types.
- Properties must be identified and acquired properly, with specific identification methods required within 45 days of the sale.
- Exchangers have 180 days to close, with no extensions (except federally declared disasters.
- For complete tax deferral, exchangers must reinvest all equity and all debt from the original property into the new property.
- Intangibles like goodwill or non-competition agreements are specifically excluded, and these make up a substantial portion of typical practice value.
- Properties may be refinanced after an exchange if tax free proceeds are desired.

Trust/LLC Installment Sales are a newer method of an installment sale utilizing a trust or LLC to defer current taxation. In these sales, assets are transferred to an independent trust or LLC in exchange for an installment note, and the entity then disposes of the assets to the end buyer. Use of this defers the taxes on the gain until principal payments are received on the note (the note may be interest-only to continue to defer all taxes). The assets are segregated in an independent entity investment account and the seller has the sole security interest, making for an installment obligation with significantly more security than one sold to a buyer with limited capitalization and business risk. Assets are typically invested in stocks, bonds, annuities, funds and managed accounts through national custodians. The interest rate on the installment obligation is influenced by the seller investment objectives and risk tolerances. The entity may hold other income producing assets (for example an installment note from the buyer). These sales must be carefully constructed by a tax professional in order to fully comply with all facets of tax and installment sale law.

A 721 Exchange may be utilized for contribution of property (practice or real estate interests) to an entity in exchange for entity interests. 721 Exchanges are used by businesses to acquire an interest in desirable assets without the payment of cash. These benefit the contributor by gaining assets in a more diversified company or a lining up future successor without any tax cost. The primary use is in practice mergers, or buyouts where the contributor locks in a future buyer.

An example of a practice sale helps to illustrate typical tax situations and effects of tax deferral. In this hypothetical $2.8M practice sale ($1.6M practice, $1.2M real estate), the majority of the value is goodwill, with 15% being equipment, inventory and non-compete agreements (fairly typical). The real estate was depreciated for 17 years (again fairly typical), and the appropriate federal tax rate is applied to each part of the sale (as described above) plus a state tax rate of 6% and AMT/deduction/ exemption phase-out of 2%. The scenario follows:

Taxable Sale

Practice Value (PV)	$1,600,000	Real Estate Value (REV)	$1,200,000
Cost Basis (usually fully depreciated)	$0	Initial Cost	$600,000
Total gain (PV – Cost Basis)	$1,600,000	Gain incl. Depreciation	$1,000,000
Tax due on gain	$490,240	Tax Due on gain	$300,000
Total Net Proceeds (PV + REV – Tax)	**$2,009,760**	**Annual Income on Net Proceeds, $2,009,760 invested @ 7.5%**	**$150,732**

Tax Deferral

Practice Value (PV)	$1,600,000	Real Estate Value (REV)	$1,200,000
Sent to Trust/LLC	$1,360,000	Sent to TIS/1031	$1,200,000
Tax due	$109,440	Tax Due	0
Cash Proceeds	$130,560	Cash Proceeds	0
Taxes deferred	$380,800	Taxes Deferred	$300,000
Total Net Proceeds (PV+REV-Tax due)	**$2,690,560**	**Annual Income on Net Proceeds, $2,690,560 invested @ 7.5%**	**$201,792**

As a comparison, a DST/1031 exchanger ends up with 33.1% more assets ($2.69M versus $2.01M). If that is carried forward to income production from the assets (the goal of most practice sellers), it results in 33.9% greater income from the assets ($201,792 versus $150,732). Thus, tax mitigation techniques can generate 25-50% more assets in a portfolio (and income production), depending upon the tax status of the sale and the state tax rate. In addition, if the assets are left in some of the tax deferred vehicles until the death of the seller, assets may transfer to the heirs with no taxes due from portions of the sale. Check with your CPA as to what taxes may be due at death and estate tax status.

As a final thought on practice sales, there are many different seller needs and desires after a sale. We have simply touched on ways to preserve assets and possibly generate more income. It is beyond the scope of this article to discuss appropriate investment and personal/family financial planning after the sale. For various reasons, many sellers wish for some cash proceeds from a practice sale (imagine that!). The dilemma is transactional cash comes with a tax cost, unless it is from financing proceeds or credit lines. Liquidity or distributions may also be desired for estate planning, gifting, long term care, or other family needs, and can be obtained with less tax cost and greater flexibility. A tax efficient practice sale is simply another tool to assist in implementation of the overall plans started many years before the sale.

Dr. Gary L. Ackerman (DVM – UGA 1981) is a former multiple practice owner. In his second life he is now licensed in securities, investment advisory, insurance, and real estate. He works with veterinarians, dentists and other professionals planning tax efficient transitions, investments, and finances. He can be reached at 804-334-7387 or GAckerman@MorseCapitalPartners.com. Please e-mail with the specifics of any proposed transaction for a customized sale & tax deferral analysis.