

Goodwill Hunting: whose goodwill, what value and what type am I selling anyway?

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“Why is a sole practitioner or associate only willing to pay one- to one-and-a-half-times practice EBIT? One predominant reason is that the profitability at which the purchaser will run the practice in the future is going to largely reflect the manner in which the vendor has run the practice...”

Good Will Hunting is a late 1990’s film about a young janitor at MIT who has an extraordinary gift for mathematics that could carry him well past his working class socio-economic roots. His transformation is assisted, in part, by Skylar, a medical student, who shows him that there can be a pretty face along with his life of the mind.

The rich diversity of perspectives in life is humorously illustrated in the following lines taken from the film:

Will: *Beethoven, okay. He looked at a piano, and it just made sense to him. He could just play.*

Skylar: *So what are you saying? You play the piano?*

Will: *No, not a lick. I mean, I look at a piano, I see a bunch of keys, three pedals, and a box of wood. But Beethoven, Mozart, they saw it, they could just play. I couldn’t paint you a picture... and I can’t play the piano.*

Skylar: *But you can do my o-chem paper in under an hour!?*

Will: *Right. Well, I mean when it came to stuff like that... I could always just play.*

Not that I am necessarily saying that all accountants lack artistic talent or share the same intuitive mathematical insights of Will Hunting. However, what can clearly be seen over many years in chartered accounting, financial planning and analysis are the dramatic ongoing differences in perspective taken by some advisors and their clients notwithstanding that they are observing the same thing.

The Sale Price: What value for a practice nowadays?

The essential information that one should glean about a general dental practice is the consistency and quality of earnings of the practice over time.

The basic premise of fair market value is generally accepted as “the price that a willing but not anxious buyer, acting at arm’s length, with full and adequate information, would be prepared to pay and a willing but not anxious seller will accept for the relevant business at the date of valuation”.

There are various different traditional methodologies for calculating the value of any business including earnings-based valuations, asset-based valuations, discounted cash flow-based valuations and “rule of thumb” valuations. Whilst asset-based valuations are less appropriate within the dental industry, net asset value still remains one of the important practice valuation inputs given fit-out of premises, plant and equipment and leasehold improvements are still an integral part of dentistry.

The important issue is that most valuation methodologies will accord sufficiently close to support each other in determining a practice price. If there is a glaring divergence between them then one should look for the reason for the discrepancy - whether a buyer or seller or advisor for either.

The purchaser: Divergences in practice valuation

Using earnings-based valuations as illustrative of the point, we have seen market averages approximating one- to one-and-a-half-times prac-

tice earnings before interest and tax expense (EBIT). Dental corporatisation has seen increases in valuations now approximating four- to four-and-a-half-times EBIT.

Why is a sole practitioner or associate only willing to pay one- to one-and-a-half-times practice EBIT? One predominant reason is that the profitability at which the purchaser will run the practice in the future is going to largely reflect the manner in which the vendor has run the practice. At least that is hoped for as a bare minimum by the purchaser after acquiring the practice. Essentially, in undiscounted or nominal cash flow terms, the purchaser is looking to claw back his or her purchase price in one year to 18 months time. This break even period is longer when you consider after tax cost and interest expense depending on what the future effective tax rate will be and what finance arrangements have been made.

The-one-and-a-half-times practice EBIT payment also reflected other factors such as:

- the cost and cash outgoing a potential market entrant or the new practice may expect to pay, to set up a practice from scratch and run the practice for the first 12 months; and
- the fact that all the purchaser was really buying was the patient list and assets and the risk of a fall in revenue was high as the owner usually left the practice after a short time

At the very best, the purchaser has plans to improve the turnover and/or profitability of the practice. Traditionally, such future business improvements or synergies are held closely by the purchaser as a way of mitigating against the risk of the practice not performing as it had in the past. This buffer is not normally given away in negotiations with the vendor (i.e. in terms of an increased purchase price offered to try and close the deal).

Insofar as the corporates are offering larger EBIT multiples to vendors, whose ongoing professional services they also seek to incentivise and retain, it is apparent that they are working on longer pay back periods than private professional purchasers. The corporates also certainly appear to be prepared to share some of their future improved profit synergies to close their individual deals.

The vendor:

Professional interest and/or discriminating investor

Insofar as a vendor's professional interests, financial remuneration and performance rights are closely aligned with the ongoing success of the dental corporate then it is obviously important to look at more than the immediate price on offer. There has been much published in this regard, both in respect of the emerging listed and unlisted dental corporate experience as well as other historic medical, health and financial service experiences. Some would have you believe that every conceivable risk will crystallize. Others express a more balanced view in that opportunities are also quantified and given credence alongside potential risks.

At the end of the day dental professional, market analyst and investor comfort will be linked to the manner in which the emergence of the following key drivers are managed:

- the security offered by contractual arrangements entered such as:
 - facility/service contracts;
 - restraints of trade;
 - underwriting profit performance; and
 - deferred or performance retention payments.
- commercial considerations such as:
 - security of the existing customer/referral base;
 - future organic or acquisitive growth of customer/referral base;
 - nature of and locations of dental practices; and
 - management of the amalgamated dental business.
- end of service period attrition:
 - quantifying the economic impact on the consolidated operating cash flow;
 - implementation of succession policies; and
 - the relationship between gross versus net attrition rates over time.

Your focus, as a practitioner, should not be on the sensationalism. Your focus should be objectively weighing up your own financial plans and personal risk profile. If the sale of your practice to a corporate is an integral part of your personal strategy then you should endeavor to examine and assess how each senior management team seeks to implement its individual corporate business plan. The corporates that succeed will be those that share their vision and insights with you while

simultaneously exhorting business plans that identify and seek to capitalize on the aforementioned future opportunities while simultaneously mitigating against the risks.

The After Tax Price: Maximizing the take home

The sale of a professional practice triggers a number of tax issues that should be considered in assessing the real rate of return on sale.

The following brief checklist sets out those "revenue account" considerations to be weighed up on both sides of the negotiating table:

- income tax implications of the transfer of depreciable assets;
 - income tax treatment of debtors;
 - the effectiveness of the ongoing structure in splitting income;
 - GST implications - the availability of the going concern exemption;
 - whether any aspects of your past or present arrangement could be affected by Part IVA of the tax legislation or other anti-avoidance provisions; and
 - pay-roll tax and superannuation guarantee implications - where you will become employees under the new structure.
- You also need to consider non-tax related issues including:
- the legal regulations governing the dental profession;
 - the professional regulations governing the dental profession; and
 - the effectiveness of the future arrangements in terms of personal liability.

However, unless you commenced your practice prior to 1985, my ongoing commentary will focus on what I consider the key determinant of any practice sale: its capital gains tax (CGT) considerations. Any sale involves the transfer of assets from the practitioner(s), the practice entity and possibly a service entity. You will have to consider whether there are any CGT issues in relation to the transfer of non-depreciable CGT assets of the practice and/or service entity such as:

- the goodwill of the practice and/or the service entity;
- non-depreciable intangible assets such as patient lists;
- shares or other membership interests in other non-corporate entities, and
- legal ownership or leasehold interests in land, buildings, etc.

Wherever possible, the sale should be engineered to take advantage of CGT rollovers, discounts and exemptions to mitigate the effects of CGT on the transfers of the business assets, the business itself, and the interests in the business and the assets held by the members of the practice.

Apart from the general 50% CGT discount (where property has been held for more than 12 months) there are four other CGT concessions specifically for small business which apply to CGT events occurring after 21 September 1999. These are:

- the 15-year asset exemption;
- the 50% active asset reduction;
- the retirement exemption; and
- the replacement roll-over.

To qualify for the concessions, a small business must satisfy a number of basic conditions including passing a \$6M maximum net assets threshold test that the business and related entities own. We will not go into the detail of the concessions as most advisors are capable of ensuring their correct application. However in summary:

- A capital gain that qualifies for the 15-year asset exemption is disregarded entirely and is not taken into account in working out the taxpayer's net capital gain for an income year. There is no need to consider the other three concessions in this case;
- Before going on to consider the other three concessions, taxpayers must first apply capital losses against the full capital gain before the capital gain (or remaining capital gain) can be reduced in accordance with those concessions;
- One then goes on to determine whether you are eligible for the general CGT discount. If so, reduce the remaining net capital gain by 50%;
- If you satisfy the basic conditions you will normally qualify for the small business 50% active asset reduction which reduces the remaining net capital gain a further 50% (i.e. 50% multiplied by 50% results in only 25% of the original net gain remaining taxable);
- Alternatively retirement relief and/or rollover relief may be utilised instead of the 50% active asset exemption;
- Retirement relief (on the 25% balance of the original net gain remaining) is subject to a lifetime \$500K limit. Retirement relief can be particularly attractive to taxpayers who are aged 55 years or over because it can be taken directly. Even if the dentist has not attained this age, retirement relief can be utilized to advantage by rolling the payment into a complying superannuation fund; and
- The rollover exemption effectively only defers the incidence of CGT by allowing one to reinvest the remaining net gain into a replacement asset. The replacement asset must be a post-CGT active business asset of the equivalent monetary net value as the gain rolled over.

The After Tax Price: An example

The operation of the concessions may be illustrated by reference to the disposal of goodwill.

In the following example (Table 1), the practitioner negotiates a sale price of \$1.5M and attributes \$160K of the consideration to practice plant and equipment. The practitioner started the practice from nothing, so the goodwill has little or no cost base. However

Table 1.

Gross sale of practice	1,500,000
<i>Allocated as follows</i>	
Plant & Equipment - tax wdv	-160,000
Goodwill	1,340,000
Capital Gain on Sale of Goodwill	
Gross assessable gain	1,340,000
<i>Less: CGT exemptions</i>	
50% general discount	-670,000
50% active asset discount	-335,000
Retirement Roll-over Relief	-335,000
Total Discount	-1,340,000
Net assessable gain	NIL
Cashflows	
Cash Received	1,500,000
Cash - Superannuation	-335,000
Tax on Superannuation - deducted	-50,250
Net Cash flow	1,114,750
Average Rate of Tax	
Total Sale Proceeds	1,500,000
Tax paid - 15%	50,250
Average Rate of Tax	3.35%

its value increased over time but the combined effect of the general 50% discount and the 50% active asset concession is to reduce the amount of the capital gain to be taxed down to 25% of the nominal gain. This is then further reduced by retirement relief on the balance.

Note that the market value of the plant and equipment sold equates with its tax written down value. Note also that personal goodwill, the single biggest capital asset, has been held for more than 12 months and that personal goodwill has been attributed to the sole practitioner.

But for the exemptions, there would have been a significant taxable gain on the disposal of the goodwill. However the only tax payable is in respect of the superannuation rollover and is only in the amount of \$50,250. Expressed as a percentage on total sales proceeds of \$1,500,000, the effective tax rate is as low as 3.35%.

Goodwill: Whose asset is being sold

Where a company starts a practice, I have heard of some advisors who automatically state that the general CGT discount will not apply. Their logic is that the 50% general discount is only available in respect of assets sold by individuals or trustees of trusts but not in respect of assets sold by companies.

Many medical and dental practices Australia-wide are structured as a practice company pursuant to the ethical rules originally agreed between the Tax Office and the Australian Medical Association and subsequently embodied in a number of public Tax Rulings and applied to other professional taxpayers (e.g. dentists, physiotherapists). In terms of sale or disposal of dental practices, there are many misconceptions in the market about their underlying tax character. The most significant misconception is that the practice goodwill is always an asset of the company. The reality is that quite often the practice is fundamentally the property of the dentist not the practice company. If goodwill exists, for example, it has on many occasions been objectively determined to be personal, rather than owned by the company and local in nature.

There are various rulings, CGT provisions and cases which support this view. There are also various other ancillary business structures and practice combina-

tions in place throughout the dental industry and whilst it sounds trite, every practice is different in its own fashion. Determining whose goodwill is disposed of and what type exists is very much a question of fact which can be determined having regard to matters such as:

- license agreements;
- personal goodwill cases;
- use of business name and ownership;
- manner of invoicing;
- collections;
- company memo and articles expression; and
- previous restructure or rollover relief.

The Final Perspective

Given the dramatic differences in perspectives and after tax outcomes, it would make a lot of sense to undertake a prudential review of how your practice entities have been set up and operated before negotiating your terms of sale and final selling price. Perhaps it seems counter intuitive but at least on one recent occa-

sion a vendor received more in “after tax” terms by actually asking for a significant reduction in sales price!

Disclaimer

This article is designed to provide generic information only and should not be viewed as a recommendation to act. Individuals should seek advice from a qualified advisor to ensure their actions are commensurate with their financial needs and requirements.

About the author

Garry Pammer is a Partner of Clark & Jacobs Accounting and Business Advisers, specialising in providing advice to dentists. Advice includes planning for your financial wellbeing, superannuation, insurance, practice management, computer software and the buying and selling of dental practices. For a free assessment of your financial position and to see how you can achieve your goals, please do not hesitate to call Garry on (02) 9264-1111.