Valuation of a Dental Practice

ROTHMOSEY
CHARTERED PROFESSIONAL ACCOUNTANTS & BUSINESS ADVISORS

October 18, 2018

Whether you have an established dental practice or you are in the process of building a dental practice, there are many reasons why understanding the value of a practice may be of interest to you. The following are instances where a business valuation of a dental practice may be needed:

- To assist a buyer in assessing whether the purchase price of the practice is reasonable;
- To assist a seller in determining the sale price to an associate or a third party;
- To assist a shareholder in understanding where value can be enhanced when planning to sell in the future;
- To determine the value of assets in a practice to be transferred from a proprietorship into a corporation;
- To determine the value of the shares of a practice for a spouse's Net Family Property value needed for matrimonial purposes;
- To determine the value of practice shares or goodwill for purposes of a corporate reorganization, succession planning or the exit of a shareholder;
- To provide information to lenders to support the value of a practice, which can assist in securing financing; or
- To determine the amount of life insurance needed to finance the purchase of shares after the death of a shareholder.

KEY ELEMENTS IN THE VALUATION OF A DENTAL PRACTICE

In order to determine the value of a dental practice, there are several key elements to be considered. A business valuation report prepared by a Chartered Business Valuator ("CBV") details an understanding of these key elements and how they impact the value of the underlying practice. Some of the key elements are detailed below.

Cash Flows from Operations

The most significant element considered when determining the practice value is the annual sustainable cash flows generated by the practice. The historical net income of the dental practice would be reviewed to understand the level of cash flows that is sustainable, whether there are any discretionary expenses deducted, and whether there are any non-recurring items. Discretionary expenses would be adjusted if it is reasonable to assume that another practitioner would not need to incur these expenses to operate the practice or if the amounts deducted did not represent fair market value of the services provided. Discretionary expenses may include such items as wages to family members, excess advertising and promotion expenses, rent paid to a non-arm's length party, and excess travel and professional development expenses. Non-recurring expenses would be adjusted, which may include such items as non-recurring professional fees, repairs and maintenance, and advertising costs.

Historical Billings

The historical revenue generated by the practice would be reviewed to understand the billings generated both by the practitioner and through hygiene services. The hours worked by the practitioner and average hourly billings would be reviewed to understand the efforts needed to generate these billings. This information may be reviewed by a potential buyer to assess whether the billings can be sustained relative to how the new purchaser would like to operate the practice.

Billings generated by associates and the agreements regarding associate fees would be reviewed. The potential buyer may consider whether the fee arrangement is reasonable and comparable to industry averages, as well as obtain an understanding of the terms of the agreement.

Equipment and Related Expenditures

The dental equipment and the annual capital expenditures required to maintain the operations impact the value of the practice.

If a dental practice has state-of-the-art dental equipment, the cash flows generated may be higher than a dental practice that has old equipment, as less repairs on the equipment should be needed, and the state-of-the-art equipment may allow the practice to provide additional services or perform procedures more efficiently.

The Operations of the Practice

An understanding of the operations of the practice is needed, as other key factors may impact the value of goodwill within the practice. The location, the nature of the patient base, specialty services and procedures provided, staff information, and capacity of the practice are some key factors that impact the value of goodwill which is a significant driver of the overall dental practice value.

For more information on how we can assist you in understanding the value of a dental practice, please contact your **Roth Mosey** advisor.

Author: JoAnne Maleyko, CPA, CA, CBV
D: 519-962-5197
E: jmaleyko@rothmosey.com

A Whole New World: Private Corporation Tax Planning

ROTHMOSEY
CHARTERED PROFESSIONAL ACCOUNTANTS & BUSINESS ADVISORS

October 18, 2018

In July 2017, the federal government released a discussion paper and draft legislation that addressed tax planning strategies for private corporations. Nearly a year after the initial release, and following public consultation, a series of government announcements in October 2017, the release of the Federal budget in February 2018, and passing of legislation in June 2018, we are now able to finally provide some additional guidance regarding the new legislation, which addresses sprinkling income using private corporations and holding passive investments inside a private corporation.

The following is a general overview of the government's new legislation in these areas.

SPRINKLING INCOME

Previously, taxpayers were able to split income with members of their family through the payment of dividends on private corporation shares held by family members, held by a family trust, or through certain other arrangements. If the family member had minimal other income, this allowed dividends to be paid from the corporation with very little or no personal income tax.

Beginning in 2018, subject to certain exceptions described below, only reasonable dividends paid to family members of the active shareholder will be taxed at the family member's marginal tax rate. To the extent a dividend is considered unreasonable, it will be taxed to the family member shareholder at the highest marginal rate of tax, currently 46.84% in Ontario. This has been accomplished through expanding the tax on split income ("TOSI") rules, which previously applied only on amounts received by minors.

The new legislation provides a number of specific exclusions to the TOSI regime, the most relevant of which are as follows:

a) **Excluded Business Test:** Dividends paid to adults **aged 18 or over** are excluded if the individual has made a substantial labour contribution (generally an average of at least 20 hours per week) to the business during the year, or during any five previous years. Individuals who are indirect shareholders of the active company, such as through a holding corporation or a trust, can meet this exclusion.

b) **Excluded Shares Test:** Dividends paid to adults **aged 25 or over** who **own 10 percent or more** of the votes and value of the active corporation are excluded if the business earns less than 90% of its income from services or from another related business, and if the corporation is not a professional corporation. Unlike the excluded business test above, the individual must hold a direct interest in the active company to meet this test. Dividends received via a holding company or a trust will not be eligible for this exclusion.

c) **Retirement Age Test:** Dividends paid to an active business owner's spouse are excluded, if the active owner is aged 65 or over, and meaningfully contributed to the business. It is the age of the active spouse that is relevant for this exception, not the spouse's age.

d) **Other Circumstances:** Dividends paid on certain shares received as a result of death or divorce are generally excluded. Other restrictions may apply.

Next Steps:

a) Identify if dividends paid by your corporation may be subject to TOSI, and document how an exception is met, including the labour and capital contributions of family member shareholders.
b) Consider restructuring the corporation's shareholdings to meet the "excluded share" test by December 31, 2018.
c) Consider restructuring the corporation's shareholdings if multiple individuals hold the same class of shares, and TOSI will apply to any one shareholder. This will allow flexibility to pay dividends to only the shareholder not subject to TOSI.

HOLDING PASSIVE INVESTMENTS INSIDE A CORPORATION

Previously, as corporate tax rates on active income are much lower than top personal tax rates, active income earned in a corporation and then invested in passive assets creates additional investable funds (without any negative tax result) relative to funds available to an individual who earns income personally, pays personal tax, and then invests in a portfolio. This deferral advantage for corporate portfolios is a result of the compounding of income on the additional funds invested.

Beginning in 2019, two measures were passed to reduce the tax deferral benefit from corporate portfolios.

Business Limit Reduction: The small business deduction will be reduced on a straight line basis beginning when passive income for an associated group of companies exceeds $50,000, with the small business deduction completely eliminated when passive income reaches $150,000. In 2018, the small business deduction reduces the corporate tax rate from 26.5% to 13.5% on up to $500,000 of active business income. While loss of the small business deduction will result in higher corporate tax up front, the after tax profits can be distributed to shareholders as eligible dividends, resulting in lower personal income tax. As such, these new measures reduce the tax deferral available, but do not have a material impact on the overall tax liability once earnings are fully distributed to individual shareholders.

For purposes of the limitation on the small business deduction, investment income of all associated companies will be considered, with adjustments for several factors, including:

a) Excluding certain net capital gains on the sale of assets and shares of an active business.
b) Excluding investment income that is incidental to an active business.
c) Including adjustments for net capital losses carried over from other years.
d) Including dividends from non-connected corporations, such as dividends on portfolio investments.
e) Including certain adjustments for income from life insurance policies.

Refundability of Taxes on Investment Income: A portion of the corporate tax paid on investment income is added to the refundable dividend tax on hand ("RDTOH") and is generally refundable to the corporation when taxable dividends are paid to a shareholder. Previously, the RDTOH recovered in a corporation was the same, regardless whether an eligible or ineligible dividend was paid to the shareholder, even though eligible dividends were taxed at a preferential personal tax rate to the individual shareholder.

Now, a refund of RDTOH will generally only be available where a private corporation pays an ineligible dividend, unless the RDTOH relates to an eligible dividend received (for example, on portfolio dividend income). To accomplish this, transitional rules were introduced to bifurcate existing RDTOH into two pools, eligible RDTOH and ineligible RDTOH.

Next Steps:

To minimize and /or prepare for the impact of these measures, consider the following:

a) Consider the benefit of paying eligible dividends in 2018 to obtain a refund of RDTOH, before applicability of the new rules.
b) Consider (with the assistance of your financial advisor) rebalancing investments to move towards capital gains and away from dividends and interest, as only 50% of capital gains are included in investment income.
c) Consider utilizing tax deferred investment plans such as life insurance and individual pension plans (IPPs).
d) Companies that lose access to the small business deduction will be subject to higher corporate tax rates. As a result, corporate tax instalment payments may not be sufficient to cover the tax balance due. The cash flow implications of this change should be considered and planned for.
e) Corporate income tax balances will be due two months after year end versus three months after year end if the small business deduction was not claimed in one of the two prior years.

For more information on how these measures may impact you and your business, please contact your **Roth Mosey** advisor.

Author: Linda Cook, CPA, CA
D: 519-962-5113
E: lcook@rothmosey.com