**Equine Practice Ownership: Is It for You?**

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1. Introduction
The objectives of this article are to discuss the risks and rewards of becoming an owner or partner in an equine practice, introduce some legal, accounting, and taxation concepts central to ownership, contrast compensation of owner veterinarians with associate veterinarians, discuss the basics of practice valuation, and outline legal entities for practices.

2. Key Points
A profitable practice that keeps being profitable will “buy itself” if the deal is structured properly and the buyer runs the business well. Choice of a legal entity for a practice, valuation of the business, crafting of the terms of a sales or merger deal, and preparation of the legal and governance documents that accompany practice ownership require thought and study, solid negotiation, and a lot of seasoned advice. The counsel of seasoned appraisers, accountants, and attorneys, although expensive, will pay off in the long run.

3. Overview of the Issue
Why Buy In?
Buying a part or whole interest in an equine practice has many rewards, including an exciting chance to develop and steer a practice that delivers the standard of care that you (and your partners) choose, the satisfaction and autonomy of making decisions that support the lifestyle that is chosen by you and your partners, and the potential for substantial personal compensation. Additionally, the entrepreneur’s dream of developing a business that can be sold at a later date frees the seller to enjoy a secure retirement or career change.

Individuals who have the intelligence and discipline to earn a veterinary degree often have great mental “wiring” to tackle the complexity of running a business and can develop the necessary skills and resources to manage a practice successfully through study and effort.

What Are the Responsibilities?
Owners wear many hats. Practice owners are responsible for running their businesses in addition to performing their standard clinical work. The areas that owners deal with include the following.

- Facility management.
- Employees: hiring, payroll, compensation, training, and termination.
- Human resources: benefits, compliance with employment laws, setting and enforcing workplace policies, and retirement planning.
- Accounting and finance.
- Legal contracts and compliance with all governmental laws, general business practices, and professional practices.
The list is long and at first glance, overwhelming, but it is not unmanageable. Many resources are available to help manage these responsibilities. Human resource companies and payroll services can handle outsourcing of benefit and human resource issues. Accountants, bankers, attorneys, and insurance agents are essential partners in handling legal and financial matters. Practice or office managers can handle many of the day-to-day details of some of the above responsibilities.

There is a great sense of pride in orchestrating the many ringed circus of your own business. Judicious selection of help from outside professionals and well-trained staff will ease the load and free the owner to concentrate on the “big picture” work of strategic planning, marketing, budgeting, and overall vision of the business.

What Are the Risks?

Buying any business incurs risk. Major risks include low profitability and catastrophic loss. If you do not make as much income as you planned, you will have difficulty meeting expenses, making the buy-in payments, and paying yourself. Note that “paying yourself” is listed last, because this is the order that the money is available. Additionally, an accident or “act of God” could damage your property, your customers, your employees, or yourself. Finally, it may be difficult to leave after you are in a business.

Some other factors out of your control may affect the long-term operation of your business: the local economy may stagnate, the death, divorce, or disability of yourself, partner, or key employee may occur, and the current climate of horse ownership may change in 10–20 yr.

It is complex and expensive to enter a buy-in agreement, it is complex and expensive to run a business, and it is complex and expensive to sell a business. However, proper management should produce the cash flow needed to fund all three elements of the business cycle. Mistakes are part of owning a practice, and tenacity is a must for the long haul.

What Are the Financial Rewards?

The risk that is assumed when a practice is purchased is balanced by the financial rewards of ownership as well as the intangible rewards discussed above. Some rewards are that the profits of the business are distributed to the owners in any one given year and equity is built in the form of practice value, which can be sold to subsequent owners. Also, rental income may be realized if the owner owns the real estate, and sale of real estate may be part of a long-term transition plan. However, most practice management experts advise that the corporate structure of a veterinary practice be separate and distinct from the entity that owns the real estate.

What Is Profit and How Does It Differ From Net Income?

The term profit is often confusing. Understanding a few economic terms is needed for a simple understanding of the concept of profit, which flows from the bottom line or net income. Gross income is the money coming into the practice, primarily because of fees. The cost of goods sold is the money going out of the practice to pay for drugs and supplies used to deliver veterinary care. The expense is the money going out of the practice for the long list of other costs that are incurred by the practice (wages, office and barn supplies, rent, utilities, vehicle costs, insurance, professional fees, payroll and other taxes, continuing education, office expense, repairs and maintenance, etc.). Depreciation is a special kind of expense where the cost of acquiring a fixed asset like a truck or X-ray machine is spread out over time to balance the cost of acquisition over the expected life of the item. Amortization is similar to depreciation in that it is a special kind of expense applied to the cost of acquiring an intangible asset like a mortgage or goodwill purchase. Net income is the money that is left over after the cost of goods sold, ordinary expenses, depreciation, and amortization are subtracted from the gross income.

Profit is the net income that remains after the owners have paid themselves for their work, both as veterinarians and administrators (if they do not hire someone to do the job). A practice that consistently throws at least 10% of gross income off as profit is desirable. A practice that has profits approaching 15% is highly desirable. As long as ethical accounting standards have been applied, historical profit can easily be determined by examining the tax records of a practice.

The exact distribution and definition of profit is dependent on the business structure of the practice (sole proprietorship, S corporation [S corp], limited liability company [LLC], C corporation [C corp], etc.). The explanation that follows is a starting point to understand basic practice economics. The reader should understand that specifics will vary with the entity, but the general concept stays constant. More information on entities is at the end of these notes.
How Is the Owner of a Practice Paid?

Many different compensation schemes exist, but practice management consultants often advise a tiered structure that links pay to the various “hats” that owner equine veterinarians wear. A simplified tier structure is described here, and the results are illustrated in the example below.

1. Pay for Being a Veterinarian

Owners are compensated for the clinical work they perform and the resultant gross billings that are collected. They should be paid similarly to associates in terms of the formula applied. Generally, this ranges from 20% to 25%.

2. Pay for Being a Manager

Owners are heavily involved in the day-to-day management of their companies as well as the long-term strategic planning, tax preparation, accounting, policy setting, etc. It is common to see compensation formulas where a percentage of practice billings are paid to the owner(s) as remuneration for this work. Percentages vary from 2% to 5% of total collected fees, but 3% is most common.

3. Profit or Return on Investment

The return on investment (ROI) is the distribution of the profit generated by the business to the owners as draw or dividend. Allocation is related to ownership interest if there are multiple owners. ROI is sometimes capped at a certain percentage, and excess profits are distributed according to a separate formula.

4. Example

This example analyzes a year of gross income, expenses, net income, and individual doctor billings for a fictional four-doctor practice called HORSES R US. It is an LLC, so the owners are compensated out of draw of net income. Two doctors are owners, and two are associates. The practice grosses $1.2 million. Owner 1 grossed $300,000 of the gross income and did one-half the management. Owner 2 grossed $325,000 of the gross income and also did one-half the management. Owner 1 owns 60% of the practice, and owner 2 owns 40% of the practice. Associate 1 grossed $300,000, and associate 2 grossed $275,000.

$1,200,000 (gross income)
  - $300,000 (cost of goods sold)
    - $520,000 (expenses)
  - $80,000 (depreciation/amortization)
    = $300,000 (net income)

Payment of part of net income to owners as production for management for work done uses the following equations.

\[ \text{total compensation for owner 1} = \frac{1}{2} \times \text{net income} \times 60\% = \frac{1}{2} \times 300,000 \times 60\% = \$90,000 \]

\[ \text{total compensation for owner 2} = \frac{1}{2} \times \text{net income} \times 40\% = \frac{1}{2} \times 300,000 \times 40\% = \$60,000 \]

\[ \text{total compensation for owner 1} = \frac{1}{2} \times \text{net income} \times 60\% = \frac{1}{2} \times 325,000 \times 60\% = \$97,500 \]

\[ \text{total compensation for owner 2} = \frac{1}{2} \times \text{net income} \times 40\% = \frac{1}{2} \times 325,000 \times 40\% = \$65,000 \]

Total net income paid out to owners for work

\[ \text{total compensation for owner 1} + \text{total compensation for owner 2} = \$90,000 + \$60,000 = \$150,000 \]

\[ \text{total compensation for owner 1} + \text{total compensation for owner 2} = \$97,500 + \$65,000 = \$162,500 \]

Payment of remaining profit is ROI. Profit remaining is the original net income of $300,000 – $120,250 = $179,750. This is 10% of gross income, which is a reasonable rate of return. It is split up according to ownership of practice shares. Therefore, owner 1 (60%) gets $72,150, and owner 2 (40%) gets $48,100. Owner 1 gets a combined income $159,150 from vet work ($69,000), management ($18,000), and profit (60% = $72,150). Owner 2 gets a combined income of $140,850 from vet work ($74,750), management ($18,000), and profit (40% = $48,100).

The two associates each are paid a compensation package, including benefits, that works out to 23% of their gross production (note that the owners are paid similarly to the associates for clinical duties). Associate 1, who grossed $300,000, gets a package worth $69,000. Associate 2, who grossed $275,000, gets a package of $63,250. These associate wages and benefits would have been reflected above as expenses.

There is a big difference between the income of the owners and associates. But remember, it is compensation for a risky and labor intensive enterprise, and 10% is a fair return on this sort of investment. Somebody has to own all the equipment, oversee the employees and physical plant, set fees, do planning, etc. Owners are taxed at a higher rate than employees and may be funding certain benefits programs themselves. Furthermore, new owners rely on draws similar to the example above to fund periodic practice payments.

A practice that throws off strong profits and is managed well to create a profit level of 10% or more year after year will generate enough cash to fund the buy in if the deal is structured with carefully considered terms (down payment, interest rate, and length of loan).
How Is a Practice Valued?

Practices are appraised by individuals trained and certified in business valuation theory. The most accurate, in-depth valuations are done by certified public accountants who specialize in serving the veterinary profession. Practice brokerage companies are also frequently used to value practices. The appraiser will require comprehensive support documentation from the current owner; this includes at least 3 yr of tax returns and payroll records as well as complete lists of all equipment and inventory on hand, accounts receivable, cash and liquid assets, liabilities, and accounts payable. A period of 4–6 mo is needed to collect the documentation and complete the valuation. Real estate is sometimes included in the practice valuation, but more commonly, it is held in a separate company. A practice valuation will cost several thousand dollars and arrive as a complex, well-referenced document.

One common formula for the actual practice value is the summation of a fair estimate of the value of tangible assets such as equipment, inventory, investments, and working capital plus real estate, if applicable, minus liabilities, added to the estimated value of patient records and the calculated goodwill of the business. **Goodwill** is defined as “the value of a company’s name and reputation, its customer relations and other factors which, although intangible, give a concern its competitive edge and produce better than typical future earnings.” It can be calculated by multiplying excess earnings by a capitalization rate of 3–5 (5 is used most commonly). **Net excess earnings** is an accounting concept that describes the money left over after all legitimate expenses have been paid, and it is a measure of profitability.

**Example**

The **HORSES R US** practice in the example grosses $1.2 million and nets $300,000. The owners contracted a veterinary appraisal company, **PRACTICES R US**, to value the business. The appraiser visited the practice and analyzed 3 yr of tax and other financial records. Mathematical calculations from the appraiser listed the value of the practice as:

- **Tangible assets and patient records** = $400,000
- **Goodwill** (average excess earnings of $80,000 × 5) = $400,000
- **Value of the practice** **HORSES R US** = $800,000

If owner 2, who owns 40% of the practice, wanted to buy out owner 1, he would have to come up with $480,000 ($800,000 × 60%). This sounds like a lot of money (and it is), but if owner 1 was no longer working, owner 2 could hire an associate veterinarian and additional support staff to do the clinical and management work recently done by owner 1. Then, if owner 2 had the management savvy to keep the profitability at the same levels, an additional $66,000 would be available in a given year to fund practice down payment and buy in.

This is a simplified example. Generally, several methods of valuation are applied to a set of practice financial data and demographics and averaged to come up with the exact appraised value.

**Will a Bank Finance the Purchase of a Practice?**

Generally, banks will not finance the purchase of a practice, at least not for 100% of the practice value. Banks do not lend money for intangible things like goodwill. Often, the “paper” on a practice sale transaction is held by the person who is selling the business. In this case, a promissory note is drawn up, the terms of repayment are defined, and the buyer gives the seller a down payment on the amount owed; the buyer then makes payments of principle and interest on an amortization schedule that lasts 5–15 yr. Some buyers secure financing through special veterinary finance companies. These companies generally charge hefty interest rates. However, they may offer flexible terms that are attractive for the buyer and allow the seller to walk away from the sale after the transaction is complete.

The financial motives for buying into a practice and the increased compensation of owners that can fund the transaction have been described. What else does a veterinarian need to know about the purchase?

Any practice sale transaction is a complex business deal requiring the assistance of an experienced accountant to help negotiate terms and structure of the deal, a corporate attorney to resolve details of how the company will be structured and overseen, and an insurance agent to insure the assets in the business, provide liability coverage, and obtain suitable life insurance for the principle parties. Considerable time will be required for negotiation between the buyer and seller before a final agreement is inked. Numerous documents must be drafted, including but not limited to a bill of sale, a covenant not to compete, a promissory note, and a purchase agreement. It is common to draft these items after the buyer and seller have agreed to the general conditions of purchase price and allocations by signing a letter of intent between the buyer and seller. Some state laws require filing an operating agreement or other type of governing document, paying fees for official filing of the entity with the state, and documenting transfer of shares or stock. Contracts may have to be prepared as well. Expect to incur professional fees in excess of $10,000 to complete the sale of most practices or buy-in agreements.

Many of the costs that are incurred in the purchase of a practice are recovered over time by deductions on the buyer’s tax return. Tax considerations are key focus points for both the structure of any sale deal and the negotiation process with the seller. Sometimes, the tax issues will be equally favorable...
for buyer and seller, and other times, the deal terms may favor one party. Tax considerations, which vary greatly from one state to the next, are one more reason to consult seasoned, informed professionals on any practice sale and to “look at all the angles” before signing any agreements.

The decision to buy into a practice or purchase one outright is a complex one. Owning a practice is not for every veterinarian, but it is a great adventure for those who take on the challenge.

4. Additional Detail
The legal structure of the business entity of the practice has a major effect on the sale situation. Details of the transfer of veterinary businesses and ongoing operation of growing practices depends on the laws and taxes applied to the legal structure of the entity being transferred. The choice of the best structure for a given practice revolves around examining three variables: the tax effects of the chosen structure, the state laws that pertain to the entity under consideration (these vary greatly), and the suitability of the entity in question from a succession planning standpoint.

The “best” structure will vary from practice to practice and state to state. It is wise to seek the advice of accountants and attorneys familiar with veterinary practices and state law before selecting an entity. Formation of the chosen entity should occur before any practice sale occurs, preferably at least 1 tax yr.

I. Sole proprietorship
A. This option is a simple, unincorporated business with a single owner.
B. The owner is personally liable for all the obligations of the practice and pays self-employment taxes on a “Schedule C” tax return.

II. Partnership
A. A partnership exists when two or more individuals operate a business for profit.
B. The general partners are responsible for all debt.
C. The tax treatment can be “flow through,” meaning that the gains and losses can be passed from the entity to the owners.

III. Corporation
A. This option is a business organization that is recognized as a legal entity separate from the people who own it, which shields the stockholders from liability.
B. Corporations must be registered as such in the state of record and adopt bylaws for governance.
C. Two types of corporations exist.
   1. Subchapter S corps have gain and loss “flow through” to the shareholders for tax treatment. This allows income to be split into W-2 wages that reflect the work product (clinical and management) of a shareholder as well as additional dividends of profit. The profit portion receives favorable tax treatment.
   2. C corps have gains and losses retained in the entity. The corporation pays tax on its profits, and these profits are “double taxed” when they are disbursed to shareholders.

IV. Limited Liability Company (LLC)
A. In these business entities, the owners have limited personal liability, but the profits and losses can be elected to “flow through” to the shareholders.
B. Setting up an LLC is as formal a process as setting up a corporation, and it requires attorney guidance to draft the required articles of organization. These articles dictate how the company will be run and how the profits will be distributed.

V. Limited Liability Partnership (LLP)
A. LLPs are similar to LLCs with the same formality and same tax treatment.
B. The articles of organization of an LLP often stipulate that it is operated and managed by its partners equally.

It is common for modern multi-member veterinary practices to choose a subchapter S entity or a PLLC (professional limited liability company) format for succession, liability, and tax reasons.

The exact structure of the transfer of assets (in the case of a sole proprietorship) or shares (in the case of an S corp, C corp, or PLLC) is as varied as the people that enter practice ownership. Sometimes, an entity is purchased outright, and other times, it is purchased in small fractions over several years. Two entities may merge and work out the balance of who owns what by complex calculations. The terms and structure of a buy in or sale are but one part of “the art of the deal” and crafting them carefully, using the seasoned advice of professional tax and legal counsel, is central to the success of any new practice owner over the long term.

5. Summary
Although practice ownership is not for everyone, it is a great career move for those who step up to the plate. Counsel from seasoned tax and legal experts coupled with careful valuation of the business in question and study of basic practice management concepts by buyer and seller can make for a happy and profitable transition for all parties.

Equine practitioners are challenged to consider ownership as a path to a secure future. Many great opportunities and options will be available in the next decade.

Reference