PRACTICE MANAGEMENT

NOTES

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Financial arrangements in an oral and maxillofacial surgery practice

This is the second of a two-part series on financial arrangements in an OMS practice. Part I, which accompanied the March/April issue of* AAOMS Today*, addressed considerations and sharing arrangements during the associateship and buy-in phases of a partnership. Part II, presented here, focuses on methods of compensation, particularly in the buy-out phase.

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Methods of Compensation

A critical aspect of the doctors' and practice's relationship, operation and continuation is the method of compensation or allocation of income and expenses. Another related and critical aspect is the matter of expenses and expense sharing. There are three main types of expenses—fixed, variable, and direct or personal.

Fixed expenses are those that remain relatively constant regardless of the volume and production of the doctors. Rent, depreciation, insurance, property taxes, dues and licenses are examples of fixed expenses. Supplies, certain wages and postage are variable expenses that fluctuate with the professional services performed.

Direct or personal expenses are those allocated directly to the doctors such as vehicles, travel, continuing education and life insurance. Regardless of their type, all expenses affect the net profit and cash flow of the practice.

There are probably as many methods of income sharing as there are types of practice arrangements. There are also many considerations that greatly affect income division and revenue production. Such considerations include but are not limited to ages and health of the doctors; length of service with the practice; standards of living; financial, college, retirement and estate planning; doctors' desire to reduce their normal schedules; emergency call; and marital status. There is no single "right" or correct" method to determine income allocation in a professional practice. Determination requires personal and professional consideration, deliberate analysis, consultation with advisors, experimentation and, most of all, fairness. Very important in income division is the fact that the doctors have the right to amend or alter any method in place or even change the entire method at any time. Not only do the doctors in the practice want to have fairness in assignment of patients and cases, they want to have a method for income division that is reasonable, workable and fair. The following are general methods for income division from which most other methods are derived:

- **Fixed salary-doctor junior.** In this basic method, doctor junior receives a fixed salary with benefits and annual increases *without* any consideration for income adjustments. At the end of five years, as the Internal Revenue Service requires, doctor junior pays a reasonable amount for the purchase of her/his stock or unit purchase and becomes an equal owner in the practice.
- **Fixed salary plus incentive.** This is a variation of the fixed salary method. The doctors agree upon a reasonable annual base salary plus incentive compensation and benefits, as described above, with consideration for annual increases. In both cases, most benefits are laddered over five years so that at the end of the term, the doctors receive the benefits equally. Vehicle expense is a good example. In year one doctor senior receives $500 per month for vehicle expenses and doctor junior receives $100. During the following years, doctor junior receives $100 increases so that at

the end of five years, each doctor receives $500 per year. Similar arrangements can be made for time and costs for continuing education, vacation, personal and sick days and other benefits. At the end of five years, doctor junior will pay for his stock or unit interest and become an equal owner of the practice.

- **Equal.** This method was common many years ago but less so today. Doctors starting out together frequently use this method. In its simplest form, after deducting all expenses, the doctors in the practice equally split the net income and, if in a junior doctor's buy-in, add or subtract the income adjustments. Direct expenses may or may not be factors.
- **Production/collection percentage.** Each surgeon's compensation is based upon total revenues each surgeon produces and the practice collects as a percentage of total practice collected revenues. This is the method applied in the example and pro-forma in Part I of this article, which published with the March/April issue of *AAOMS Today*. During the first year of the buy-in arrangement, projections indicate that doctor senior produces 65% and doctor junior produces 35% of the practice's collected revenues. Therefore, doctor senior will receive 65% and doctor junior will receive 35% of the net income plus and minus the income adjustment. As doctor junior's professional, marketing and other skills increase, doctor junior's percent of production/collection increases until, hopefully, the doctors reach pretty close to equal production/collection in four or five years. True, the first year of the buy-in may be somewhat difficult for doctor junior. Doctor junior, however, is making an excellent investment in his career and future.
- **Production/collection less expense percentage.** This method is similar to the previous method except that each surgeon is responsible for, and the practice deducts, the same percentage of the true operational expenses from each surgeon's gross compensation. For example, if doctor senior produces 65% of the collected revenues, doctor senior would be responsible for 65% of the true operational expenses. Personal expenses such as vehicle, retirement, travel and continuing education are paid by the practice but allocated to and deducted from each doctor's compensation.
- **Percent equal/percent of production/collection.** This method is a hybrid, a combination of equal and percentage divisions. It equalizes certain differences that may arise in patient and case assignment and treatment, required time out of office (hospitals, ambulatory surgery centers, court, etc.), desired time to reduce schedules, etc. Percentages run from 50% equal/50% based upon percentage of production/collection to 20% equal/80% based upon percentage of production/collection. If indicated, income adjustments can be added or subtracted.
- **Percentage of senior doctor's net income.** Using this method, the doctors in the practice divide and share income on doctor junior's annually increasing percentage of their net incomes on which they pay taxes at their ordinary tax rates. Annual percentages commence and vary from 40% to 60% with annual increases of 10% until income is either divided equally or according to one of the other acceptable methods. At the end of the buy-in period, the doctors still have to address the matters of the accounts receivable and payable and stock or unit value to finalize and effect the buy-in.

In today's modern oral and maxillofacial surgery practice trained surgeons are performing multiple advanced procedures such as implants and sinus lifts, orthognathic surgery, bone grafts, cosmetic procedures, and extensive trauma repair. In performing these procedures, the surgeons incur heavy expenses, including increased costs of professional liability insurance. In order to accommodate all surgeons when the caseload becomes large, the practice will set up segregated cost centers. This means that for the doctor who performs the special procedures, the practice segregates all revenues, expenses and profits associated with them in a single cost center. The center is treated as a practice within a practice and requires accommodation of the related revenues and expenses.

The documents required during the buy-in phase are employment agreements for all doctors, stock purchase, and management or administrative and comprehensive buy-sell agreements.

The Buy-out Phase

We now fast-forward many years. The practice has grown and prospered and the doctors have achieved a great deal professionally, personally and community-wise. The well-planned associateship and partnership have been successful. Doctor senior has indicated his intention to retire. The practice is no longer a one-doctor practice so the doctors must find a qualified replacement, which requires considerable time, effort and expense. The doctors have a general transition plan that they commence to implement. This is the point at which their important, customized Buy-Sell Agreement comes into play. In addition to premature death and permanent disability, bankruptcy and other voluntary and involuntary reasons, the Buy-Sell Agreement specifically addresses doctor senior's retirement. In this case, the pertinent features are:

a. Notice – Doctor senior is required to give 12 months notice of retirement in writing. If not, her/his payout would be reduced 5% per month up to a maximum of 50%;

b. Right and obligation of doctor senior to transfer his interests to the business entity, other shareholder(s) or member(s), non-shareholder or non-member;

c. Obligation of doctor senior to have a covenant not to compete similar to doctor junior's upon his final post-employment departure;

d. Agreed values and amounts to be paid for stock or units and intangible assets (goodwill, covenant not to compete, records, etc.);

e. Terms of payment for the assets – initial and subsequent payments, including interest and security;

f. Right to purchase any personal insurance for cash surrender value;

g. Right to receive normal and accrued compensation up to date of departure;

h. Responsibility to repay all loans and other obligations;

i. Practice's right to pay to departed party or parties no more than 5% of gross revenues per year; and

j. Right or obligation of doctor senior to work part-time as an independent contractor or at least until the practice finds and hires a replacement provided that she/he is physically, mentally and otherwise competent.

Similar to doctor junior's buy-in, doctor senior's payout shall be divided into two portions—a) stock or units and b) intangibles. The doctors have been diligent in maintaining and annually reviewing the original valuation and will have the specific values in place as of the date of doctor senior's retirement. The buy-sell agreement contains the stock purchase arrangement similar to the former buy-in purchase. Today case law and the Internal Revenue Service take the intangible asset portion to another level and break it into two portions—a) personal or professional and b) commercial, enterprise or entrepreneurial. In this case, the corporation or limited liability company, the other shareholder(s) or member(s) or the new qualified associate shall purchase the stock portion directly from doctor senior. They also shall purchase the personal or professional intangible portion from departing doctor senior, which can be structured either fully or partially through the business entity. An important feature of this arrangement is that doctor senior shall pay all taxes except interest for the stock and intangible payments at his long-term capital gain rate, which is currently 15%.

The breakouts of the assets and their values in this case are:

AGREED VALUES/ALLOCATIONS
PRACTICE FAIR MARKET VALUE
100% - $ 1,000,000

Stock value – 100%	
Stock value	$ 150,000
Each doctor's 50% Interest	$ 75,000
Goodwill value – 100%	**$ 850,000**
Company value - 33 1/3% (Commercial)	$ 283,334
Dr. senior's value - 33 1/3% (Personal/Professional)	$ 283,333
Dr. junior's 33 1/3% Interest	$ 283,333

The above agreed values and allocations illustrate that doctor senior's payout upon retirement shall be $75,000 for stock and $283,333 for intangible assets, a total payout of $358,333. According to the terms in the buy-sell agreement, he would receive the combined amount over five years plus interest at the prime rate on the date of the anniversary of his departure.

Summary

We have come full circle. This two-part article has addressed financial aspects of an OMS entering an associateship, commencing and completing her/his buy-in and navigating doctor senior's departure and payout. We covered a great many years and major aspects and realized how involved and complex the processes truly are. It became apparent that, like each OMS, each transition is unique and special. We started with the "Fact Pact" or "Associate Terms" and realized how the comprehensive valuation plays an important part from the beginning and through the entire process. We understand that we need to have a team of competent, experienced advisors to guide us through the intricate issues and financial arrangements.

We saw how the buy-in can be structured to include the required stock or unit and intangible asset purchases, which should be favorable to the parties. We quickly observed that taxes are a major factor throughout the multiple transactions. We emphasized expenses, more particularly, their necessary control. We found out there were many methods of compensation and that we can alternate among them whenever the situation warrants. At all times, regardless of the method, in order for the method to work it had to be fair and equitable. Where practical, I presented examples, illustrations and formulas. I listed the main documents that are necessary to implement the three phases.

We ran through the dynamics of an OMS's departure and how the myriad details included in the comprehensive buy-sell agreement affect a smooth exit. We saw that by working together, having common goals and objectives and being fair and reasonable, an oral and maxillofacial surgery practice can be extremely lucrative and rewarding.

This is number 110 in a series of articles on practice management and marketing for oral and maxillofacial surgeons developed under the auspices of the Committee on Practice Management and Professional Allied staff and AAOMS staff. *Practice Management Notes,* from 2002 to present, are available online at *aaoms.org.*

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