When Sid and Bill met Russell

Russell Abrahams explores the purchase of an incorporated practice.

Whether you are selling or buying an incorporated dental practice, it's wise to be prepared in order to achieve a successful transaction. To illustrate the complexities, I have created a theoretical dental practice owned by Sid, who incorporated his mixed practice some years ago, and now owns Sid Limited. The gross fees total £800k and there is a 15 year lease over the practice property at a full market rent. We will assume that the value of the goodwill and equipment is 100 per cent of its gross fees.

The deal is that Bill, the buyer, buys Sid Limited for £800k, with the assistance of one of the dental sale agencies. This article is about a close inspection of the adjustments that need to be made to the purchase price of Sid Limited, in order to reflect the commercial deal that has been struck.

Firstly, since Sid Limited will have assets and liabilities, adjustments need to be made to the purchase price. An example of a very significant asset might be a cash deposit of £100k in the company's bank account. An example of a very significant liability would be the company's tax bill. The tax bill may not be payable until three months after completion of the sale, but the profit was made prior to the sale, so the tax is Sid's liability. Another significant liability could be the clawback payable under the NHS contract relating either to the current NHS year or the previous NHS year.

So how are these complicated ➲

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adjustments dealt with? Unfortunately, these issues cannot be dealt with by a simple apportionment clause that you might have in a conventional sale agreement. Such a clause would say that if the seller has paid rates for the whole financial year ending March 31, and completion takes place on the previous December 31, then the buyer reimburses the seller in a sum equal to one quarter of the overall business rates bill.

On the sale of Sid Limited, all of these adjustments are fed through to a set of accounts known as completion accounts. The sale agreement will say that the purchase price will be £800k, but it will be adjusted, upwards or downwards, depending on the net asset value of the company as shown in the completion accounts.

The completion accounts are required to be prepared in accordance with strict instructions. The only aspect of the completion accounts that is relevant is the balance sheet. This will show the net assets of the company, as at the completion date. The goodwill and the equipment will be shown at nil value. If Sid intends that the stock is included in the sale, stock will also be shown at nil value.

All of the other assets and liabilities of the company, including tax liabilities, clawback, cash at bank, HP liabilities, general creditors, book debts, employee claims, the obligation to pay associates' fees and even the cost of preparing the completion accounts are all totted up in the balance sheet as at the completion date, which forms part of the completion accounts.

One major liability that may appear in the balance sheet is the incorporation loan. Let us assume that Sid incorporated the practice two years ago and the practice was then valued at £700k. There was no bank debt. At that time, Sid would have transferred the business to Sid Limited for a purchase price of £700k and Sid Limited would, on completion of the sale, have owed Sid £700k.

Sid Limited made a profit of £125k in each of the two years following incorporation and prior to the sale of Sid Limited. The company will have paid £25k in corporation tax in each of those two years and will have repaid to Sid £100k of the debt in each of the two years. It follows that, at the moment of completion of the sale of Sid Limited, Sid is still owed £500k by Sid Limited.

This (significant) adjustment is achieved by technically reducing the purchase price of Sid Limited to £300k (still subject to adjustments for assets and liabilities shown in the completion accounts) and for Bill to lend to Sid Limited, on completion of the purchase, the sum of £500k, which, again, on completion, Sid Limited repays to Sid.

The effect of this series of transactions is that Sid is effectively paid £800k for the practice (including the repayment of debt), and Bill effectively pays £800k for Sid Limited albeit described as £300k for the shares and £500k by way of a loan to Sid Limited.

There are a number of tax consequences flowing from these transactions that are, again, outside the scope of this article. But we have now addressed the fact that when you buy an incorporated dental practice, you pay the headline purchase price, subject to adjustments, for net assets (other than goodwill and equipment) at the time of completion. This gives rise to a significant degree of uncertainty. It is all very well saying that Bill will buy Sid Limited for £800k, plus or minus a cash adjustment, but how much will that cash adjustment be?

The reality is that Bill will be borrowing to his maximum extent to buy the practice and his finances will be directly linked to £800k. If what drops out of the completion accounts is an additional (albeit entirely legitimate) cost of £100k, where is that extra cash to come from?

There are two essential controls that Bill's solicitor must ensure are incorporated within the sale agreement. First and foremost, there must be an upper limit that Bill should be required to pay for the additional assets. In this case, the upper limit might be £20k. It follows that even if the additional balancing sum is £40k, the maximum that Bill could be expected to pay is £20k.

Secondly, and more importantly, Bill must require Sid to provide a pro forma balance sheet that anticipates the likely asset and liability position on the completion date. This should assist the parties to nail down, contractually, the adjustment likely to be required as a result of the completion of the completion accounts.

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