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Marmer Penner Newsletter

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VALUATION OF PROFESSIONAL PRACTICES OTHER ISSUES

In our last two newsletters, we considered the advantages and disadvantages of valuing professional practices based on rules of thumb versus earnings based approaches. This final installment of the primer on the valuation of professional practices deals with ancillary issues:

a) common ”business” expenses with a personal element;
b) often missed assets; and
c) contingent tax liabilities.

When valuing a professional business practice, the same adjustments that are made to determine maintainable earnings of the practice will also be considered when determining the income over which the professional has access and control for support purposes. Taxpayers have always had an economic incentive to include questionable business expenses as it lowers their personal income tax liabilities. Upon separation, many taxpayers see the additional opportunities to reduce support by becoming more aggressive in their expense claims. The expenses that often include the highest levels of abuse include the following:

a) home office expenses;
b) automobile expenses;
c) travel expenses;
d) meals and entertainment;
e) promotion;

f) club dues;
g) legal and accounting fees; and
h) repairs and maintenance.

Home office expenses usually consist of an allocation of home expenses such as mortgage interest, property taxes, insurance and utility costs. Allocating a portion of these expenses as business expenses is appropriate for income tax purposes where a portion of the home is used to meet clients or conduct business. However, in most cases, no incremental cost is incurred as a result of the home office. Accordingly, it may be inappropriate to consider these expenses when determining maintainable earnings of the practice. Items (b) through (h) above generally require adjustment when non-business expenses are paid by the professional practice as business expenses.

When valuing a professional practice either on a rule of thumb or on earnings approach, it should be noted that both these approaches tend to provide the value of the practice's goodwill. They do not necessarily include the practice's tangible assets. In many cases, it is accepted that the goodwill of the practice is added to the net book value of the practice to arrive at the practice's value. It should be noted that certain practice assets may not appear on its balance sheet. These off balance sheet assets can include the following:

a) unbilled work-in-process;
b) unbilled disbursements;
c) collectible receivables which have been written off for tax and accounting purposes; and
d) retirement benefits available to partners.

To determine unbilled work-in-process, the valuator must review time and billing records. In general, unbilled work-in-process would be more significant in an accounting or legal practice than in a health care practitioner's practice. Similarly, unbilled disbursements may have been expensed by the practice without yet recording the corresponding receivable from the client.

Where significant bad debts have been written off, the valuator will review the reasonableness of the write-off by examining the circumstances leading to the

write-off, any subsequent collections and efforts made to collect the unpaid fees.

With respect to a partner's retirement benefits, one needs to review the partnership agreement to determine any entitlement to post-retirement income, retiring allowances or goodwill payments.

When valuing an incorporated businesses, the contingent tax on disposition of the business generally consist of capital gains on the sale of shares, or a deemed dividend on the sale of assets by the corporation followed by a wind-up of the corporation.

When a practice is unincorporated as is the case with certain professional practices, there will not be any significant income tax on the disposition of assets except for the sale of goodwill. Goodwill is an "eligible capital asset" as defined in the *Income Tax Act*. The relevance of this is that it is taxed at rates akin to capital gains. If the practitioner has purchased goodwill, then the undepreciated capital cost of this eligible capital asset must be considered as a deduction when determining the expected future tax liability on the sale of the goodwill. As with most contingent taxes, an appropriate present value factor should be considered.

Where adjustments have been made to the practice value for unbilled work-in-process, unbilled disbursements and collectible receivables written off, a tax adjustment with little or no present value factor may be appropriate.

This newsletter is intended to highlight areas where professional assistance may be required. It is not intended to substitute for proper professional planning. The professionals at Marmer Penner Inc. will be pleased to assist you with any matters that arise. Please feel free to visit our website at www.marmerpenner.com.