Dental Practice Receivables: Take Them or Leave Them?

By Mac Winston

One of the usual decisions to make when buying a dental practice is whether to acquire the accounts receivable (ARs)—those bills for dental services rendered that will not have been collected before the practice changes hands—as part of the transaction. The ARs are not purchased by the buyer in the great majority of dental practice acquisitions.

Why, and what are the implications of either course of action?

1. Tax Considerations

It might surprise you to know that tax consequences are not part of the consideration. The selling dentist pays taxes on the ARs regardless of whether they are included in the practice transaction. If the receivables are bought by the new owner, the seller immediately pays tax, at the ordinary income tax rate, on the monies received. If the ARs are not purchased by the new owner, the post-closing flow of collections from the receivables are taxed as ordinary income to the seller in the year(s) in which the monies are received.

Why is there no tax liability for the buyer, either at closing or when the receivables are collected, when the ARs are included in a practice acquisition? It is because the money collected represents liquidation proceeds on an asset that was purchased. On the books, the collections on purchased receivables are recorded as income; they are then offset, dollar for dollar, by a write-off up to the value paid for the ARs, as shown below.

Practice Income Statement with ARs Purchased—First Two Months of Operations

Collections on ARs purchased	$ 40,000.00
Collections on post-closing production	$ 60,000.00
Gross Receipts	**$100,000.00**
Write-off of collections on purchased ARs	$ 40,000.00
Post-closing operating expenses	$ 80,000.00
Total Expenses	**$120,000.00**

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Net Income/(Loss)	**$(20,000.00)**

2. Working Capital In Place of ARs

When receivables are purchased with the practice, the buyer can count on an immediate flow of income to help offset expenses until his or her own production starts generating significant income. However, when ARs are not part of the purchase, the buyer must borrow working capital or invest personal savings to cover expenses during the first month or two of the new ownership. That is normally how long it takes for collections on the new doctor's production to catch up with expenses.

Most buyers choose to borrow working capital rather than use personal funds. Because the proceeds from a working capital loan are not recorded as income to the practice, but the expenses paid with the proceeds are reported, the resulting net income reported will be no different than that reported when ARs are purchased. Compare the operating statements below.

Practice Income Statement with No ARs Purchased—First Two Months of Operations

Collections on ARs purchased	$ 0.00
Collections on post-closing production	$ 60,000.00
Gross Receipts	**$60,000.00**
Write-off of collections on purchased ARs	$ 0.00
Post-closing operating expenses	$ 80,000.00
Total Expenses	**$80,000.00**
Net Income/(Loss)	**$(20,000.00)**

3. Collections Risk vs. Reward

When purchased, ARs are bought at a discount since a collection rate of 100% is virtually impossible to guarantee. Therefore, buyers, and in particular, their accountants, tend to worry a great deal about

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matching the discount for which the ARs are purchased with the actual collections they will experience on those accounts.

Much of that worry is unfounded. The collections rate on the receivables of most dental practices is very stable and easy to see in the historical Production and Collections Reports and Accounts Receivable Reports of the practice. Thus, a buyer could make a relatively informed offer to purchase the ARs of the seller at a discount that would most likely result in no loss of value for the ARs purchased. And, if the buyer is able to negotiate a preferential discount from a motivated seller, he or she might realize a nice gain on the purchase of ARs (note that the amount by which the collections on purchased ARs exceed the price paid for them will be recorded as income).

Despite this, many buyers decide not to take the risk, given that there is some uncertainty as to the outcome of collections and that working capital financing offers a secure and predictable course of action. The scales are further tilted in favor of using working capital financing by the fact that the amount of money needed to meet the expenses of the practice in the first couple of months, while the post-closing gap between production and collections is bridged, is often less than the total cost of purchasing the ARs from the seller. Therefore, the buyer who opts to purchase the ARs will typically end up borrowing more money for the practice acquisition transaction than really is needed.

4. Other Issues

Buyers and their counsel have voiced concerns about the assumption of the billing habits, problems, issues, and the like of a seller through the purchase of his or her receivables. They have argued that by securing working capital financing and leaving historical ARs to the benefit of the dentist who produced and billed for them, they are in effect placing a firewall between the pre- and post-acquisition billing and treatment activities of the practice. Put more bluntly, they believe that by leaving the ARs to the seller and using invested or borrowed working capital, they will protect themselves from exposure to pre-acquisition billing shenanigans and/or patient treatment practices of the seller.

Another thought voiced by some is that given the relatively complex nature of the negotiations and documentation required in a dental practice acquisition transaction, the addition of issues arising out of a decision to purchase ARs may serve to further complicate the process.

It's Your Choice

In the final analysis, the choice between taking or leaving the ARs in a dental practice acquisition generally is driven largely by personal perceptions rather than quantifiable dollars-and-cents reasons. If you are the

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one making the decision, the ultimate decision may well lie with your tolerance for risk in hopes of gaining a larger reward.

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