The Wonderful World of Profit

How and Why to Abuse it … or Not

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It is no secret or surprise that many small, closely-held American business owners, including veterinarians, manage their business expenses and tax return net income (earnings) with the motive of tax minimization.

In the world of profit, taxes and practice value, "Earnings" is the balance remaining from gross revenues after all real, necessary, and recurring practice expenses have been met, including a fair market salary for the managing doctor (typically the owner). It is important to emphasize that this salary is that for being a managing doctor, not for being the owner. It is the real "profit" of the practice and the return on a hypothetical, out-of-pocket cash investment. In a well-managed moderate to high-grossing practice, earnings will range in the mid to high teens as a percentage of gross. It is the major source of practice value, often at four to six times earnings.

So let's say, for example, that two practices, A and B, are identical in characteristics and quality in all respects except profit management. One earns (tax return net) 21%, the other only 7%. For simplicity, let's say that both are determined by the appraiser to be worth 5.26 times earnings.

Gross	**Earnings**	**Multiple**
Practice A $1.0M	$210K (21%)	5.26 X
Practice B $1.0M	$ 70K (7%)	5.26 X

The Math:

Practice A: $210K X 5.26 = $1.105K (110% of gross)

Practice B: $ 70K X 5.26 = $368K (37% of gross)

However, by design, practice B pays a paltry sum of taxes due to its low profitability. The owner is not ready to sell the practice, so value is no great concern.

Gross	**Earnings**	**Tax Rate**
Practice A $1.0M	$210K (21%)	36% approx.
Practice B $1.0M	$ 70K (7%)	19% approx.

The Math:

Practice A: $210K X .36 = $75K taxes

Practice B: $ 70K X .19 = $13K taxes

In further analysis, it is discovered that the owner of practice B, ran $99,000 expenses through the practice that were not real operating expenses, but more personal in nature. Such as:

Salary in excess of fair market	$20K
Non-staff spouse	$20K
Health Insurance	$ 7K
Pension / Profit Sharing	$15K
Automobile	$ 6K
CE to Vegas	$12K
Drugs & (fishing) supplies	$ 5K
Drugs & (farm) supplies	$ 6K
(Home yard) Maintenance & Repair	$ 3K
(Home AC) Maintenance & Repair	$ 5K
TOTAL	$99K
Plus tax return net	$70K
Total earnings	$169K (17%)

So the real profit /earnings is $169K vs $70K ($99K personal expenses + $70K tax return net), and the real value of practice B1, according to the practice appraiser, is $890K, or 89% of gross.

Gross	**Earnings**	**CAP Rate**
Practice A $1.0M	$210K (21%)	19% (5.26X)
Practice B $1.0M	$ 70K (7%)	19% (5.26X)
Practice B1 $1.0M	$169K (17%)	19% (5.26X)

The Math:

Practice A: $210K X 5.26 = $1.105K (110% of gross)

Practice B: $ 70K X 5.26 = $368K (37% of gross)

Practice B1: $169K X 5.26 = $890K (89% of gross)

But "**Wait just a minute!**", says the buyer's consultant and the commercial acquisition lender. Of course the buyer, lender and consultant are ensuring that there is enough income in the "pot" to service the acquisition debt and have ample remaining for the personal needs of the buyer. They all acknowledge that some of these expenses are easily verifiable and therefore acceptable as a portion of the profit and therefore as a contribution to value. I call these the "Good Boys":

Excessive owner COS salary	$20K
Non-staff spouse	$20K
Health Insurance	$ 7K
Pension / Profit sharing	$15K
Automobile	$ 6K
CE to Vegas & France	$12K
Total	$80K

However there are some expenses that the appraiser allowed as an adjustment to earnings that are not so verifiable and therefore must come under closer scrutiny. After all, who's to say these *Supplies and M&R* expenses on the Tax Return were indeed personal to the owner, as claimed, and not real operating expenses. Probably the owner ran these through the credit card at Tackle Shack, Tait's Feed Store, Walmart and Home Depot but did not retain receipts. On the credit card bill, it can be shown how much went to each vendor but not the product purchased. Without verification, these expenses are typically disallowed by the lender and buyer's consultant, and the practice value is decreased by this factor. I call these the "Bad Boys":

Drugs & (fishing) supplies	$ 5K
Drugs & (farm) supplies	$ 6K
(Home yard) Maintenance & repair	$ 3K
(Home AC) Maintenance & repair	$ 5K
Total	$19K

So now you're ready to sell your practice, and what do you do?

If you eliminate these expenses and allow them to fall to the bottom line, the $19K goes straight to taxes and to value. At 36% tax rate, the tax over two years would be $14K. At 5.26 times earnings, the addition to value would be $100K. (Well, not quite as simple as this but close enough to make our point.)

Tax impact ---$19K X 36% tax rate = $7K X 2 years = $14K

Increased value---$19K X 5.26 = $100K

Therefore, it becomes a simple matter of stopping the Bad Boy expenses at least two years prior to having your practice appraised for selling and clean up the tax return. Go ahead and invest in taxes and salvage the balance.

Pay taxes	$14K
Sell for additional	$100K
Salvage	$86K

It is strongly advisable to have your practice appraised at least two full tax return years prior to placing it on the market for sale. A good report will identify these issues and whether you have a "profit" problem which will affect your value. The two years gives you ample time to fix the problem.