NATIONAL DENTAL LAW GROUP AT
MANDELBAUM BARRETT PC

Unlocking the Value: Equity Interests as an Option for Dental Practice Employees

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Incentivizing dental employees with an equity interest in the practice is an important tool for attracting and retaining quality dentists and support staff. Additionally, offering an ownership interest in the practice serves the important function of motivating employees to proactively pursue greater profitability, thus contributing to the practice' growth. This handbook addresses different types of equity that can be offered to dental employees, including stock options and profits interests.

1: Employee Option Plans

An Employee Stock Option Plan for corporations, or an Employee Unit Option Plan for a limited liability company are the more traditional means of granting employees equity in a dental practice as a form of compensation. Stock or unit options are also popular ways to allow an associate dentist to buy into a dental practice. While the specific terms of such Option Plans can vary greatly, the essential elements are the same: (a) the employees are given the opportunity (i.e., the option) to purchase a certain number of shares or units in the practice entity at a specified price over a limited period of time; (b) there is a vesting schedule under which the employee is granted the option to buy a certain number of shares or units each time the employee reaches a number of years of employment, and the employee has a limited "window" of time during which they can exercise these options; and (c) the Option Plan provides for a preferred price at which the employee can purchase the shares or units, or the price is set at some point below the actual value of the shares or units being purchased.

While these types of Option Plans are a popular choice for dental practice owners, there are potential downsides for both the practice and employee that all parties should be aware of. First, the employee must have the financial ability to pay for the shares or units. Although the practice can "lend" the employee the amount of the purchase price, as discussed below the employee will still have to repay this loan and may suffer an adverse tax consequence. Even if the practice ultimately forgives the loan, the practice owner will have given up part of their ownership interest without receiving any payment in return.

Second, there are certain tax disadvantages for the employee. When an employee purchases an interest in the practice and the purchase price is below the fair market value of that interest, the difference between the purchase price and the actual practice value will be considered taxable income to the employee when the employee exercises their option to purchase. Similarly, if the practice loans the employee the funds to purchase the shares or units and subsequently forgives the loan, this forgiven amount will still be considered taxable income to the employee, and the employer will be entitled to a corresponding deduction.

Finally, there are risks to offering Option Plans which many employees are either unwilling or financially unable to take. For example, as with any investment, the practice may not actually increase in value over time and may even decrease in value. Therefore, the employee's investment may be worth less over time. Further, despite having an ownership interest in the practice, the employee may have little actual control over its management because the employee only owns a minority interest. Practically this means that the owner(s) of the majority of the practice can control if and how much money is disbursed as dividends and distributions to practice owners. Unless compelled in a Shareholders' Agreement or Operating Agreement, the majority owner(s) could withhold distributions to shareholders or unit holders thus delaying when an employee receives an economic benefit as a result of their investment.

2: Profits Interests

Granting employees a 'Profits Interest' in the practice entity is another form of equity compensation that may be available to practice owners. Offering employees Profits Interests is a popular option because it allows the parties to avoid many of the pitfalls associated with Option Plans and provides several additional benefits to both the practice and employee. It is worth noting, however, that only limited liability companies or partnerships can offer employees Profits Interests. This is due to the fact that the entity must be taxed as a partnership for federal income tax purposes in order to grant Profits Interest. Although there are means by which a corporation may create an entity structure that allows the granting of Profits Interests, the permissibility of this arrangement should be discussed with an attorney who will review the laws of the relevant state.

As with Options Plans, offering employees Profits Interests grants real equity (i.e. ownership) in the practice entity. Unlike Option Plans, however, the employee's interest is limited to a portion of the practice's future profits. Additionally, Profits Interests involve an outright grant to the employee, as compared to an Option Plan where the employee must decide whether to exercise the option to purchase the equity. With Profits Interests, the employee does not pay for the Interests. Instead, the Profits Interests are granted in consideration of the employee's services and other contributions to the practice.

Because Profits Interests only grant employees an interest in the practice's future profits, there are generally two situations when the employee can receive the financial benefits of a Profits Interest. The first situation is when the practice entity (or some portion of it) is sold. However, the occurrence of a liquidity event is so unforeseeable that it is often an insufficient incentive for employees to perform well to enhance the practice's value.

The second situation in which an employee can benefit from holding Profits Interests involves providing the employee with yearly profit distributions in connection with their ownership share. Sharing in these distributions can be coupled with the employee receiving a share of the proceeds at the time of a practice liquidity event. This structure can also be combined with a vesting schedule which means that no shares of practice profits are distributed until the employee has held the Profits Interests over a certain number of years. A vesting schedule serves the goal of enhancing employee loyalty and retention.

If the practice decides to offer holders of Profits Interests yearly profits distributions, the practice has great flexibility in structuring how the yearly distributions will be calculated and how they will be allocated among different types of practice owners such as founders versus employees. The Profits Interests granted to employees can also be structured such that the yearly distributions of profits are limited to those profits realized from one location where that employee works.

Profits Interests are also attractive because they are not accompanied by tax liability to the employee. At the time Profits Interests are granted, their value is technically zero. This valuation guarantees that there is no taxable income to the employee at the time of the grant. The tax benefit for a Profits Interests holder is realized at the time of the practice sale because the receipt of the proceeds from a sale can be taxed at the lower capital gains rate as opposed to the higher ordinary income rate.

Assemble *your team*

It takes an entire team of dental industry professionals to ensure the success and growth of a dental practice no matter where you are in your professional journey. Each advisor serves a unique role in providing proper guidance to dental professionals as they navigate the successes and challenges of practice ownership.

There are six essential roles every dentist and dental specialist should consider when building an advisory team:

- **Accountant** – Understands dental practice economics and ensures accurate financials, tax planning, and practice valuations.
- **Practice Consultant** – Offers operational insight to reduce costs, improve efficiency and growth, and strengthen overall business operations.
- **Attorney** – Protects your interests by providing advocacy and legal guidance on contracts, compliance, risk management, and transition planning.
- **Financial Advisor** – Helps structure personal and practice finances for long-term stability by offering guidance on investments, retirement planning, taxes, etc.
- **Specialty Lender** – Evaluates practice cash flow and growth potential and can often offer one hundred percent financing and working capital in a dental acquisition.
- **Broker** - Assists in valuing and marketing a practice, finding opportunities to acquire and grow, and serves as a resource in helping parties reach a fair deal.

It is crucial that each of these professionals have experience working specifically with dental and dental specialty practices. Often, one trusted advisor will recommend other qualified professionals to help you complete your team.

Taking the time to build this team will provide you with the advice and perspective needed to make informed decisions throughout your career.

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