Cruising to a Crisis

Life is good for Dr. Older. Dr. Older is a mature veterinarian in the twilight of his career. The practice was paid for many years ago. On a day-to-day basis the practice presents few challenges. The house is paid for and the kids are finished university. The profits from the practice represent a greater income stream than he needs at this point in his life. Dr. Older operates a single person practice that grosses $600,000 per year and historically has netted out approximately $200,000, a pretty average practice.

Over the past five years Dr. Older has been able to work a reduced schedule which has compromised his earnings, but he has no pressure to earn more. Over the next five years he intends to gradually work less and accept that his earnings will be further compromised. The sacrifice seems acceptable; it was going to be taxed anyways. At the end of five years, he intends to sell the practice and use the proceeds from the sale to shore up his retirement nest egg.

It sounds like a good plan, but there are ramifications that Dr. Older has not considered. Over the ten years of reduced work, net income from the practice is anticipated to deteriorate by $3,000 per year. That doesn't seem too bad, as Dr. Older will still experience a net income of $170,000 in his last year of practice, more than he needs to satisfy his lifestyle.

What is less apparent, however, is that the net income of the practice over the ten years should have grown by 3% per year and should have been $268,783 at the end of the ten years, $98,783 greater than what will be experienced according to Dr. Older's plan. The real lost income is the income that should have been realized less the actual income. If this lost profit stream over ten years is taxed at a rate of 46% and invested at 6% annually, the value at the end of the ten year period is $288,185, an amount far greater than what Dr. Older has likely contemplated.

The loss of profit also has a significant influence on the sale price of the practice. The value of a practice is determined by the risk associated with the purchase and the magnitude of the profit. Assuming that the risk at the end of ten years is the same regardless of Dr. Older's strategy, the difference in net income is the sole determinant of the practice value. In today's market, $98,783 less profit will result in a reduction of practice value of $300,000 to $400,000. It is possible that Dr. Older would have been able to realize this difference in practice value free of income taxes.

Dr. Older's strategy of a reduced schedule will result in a retirement nest egg that is easily $600,000 less than he would have realized if he had maintained a full work schedule. Alternatively, Dr. Older could have worked a full schedule for seven years and fully retired three years earlier than what he planned while realizing the same retirement nest egg.

While there are many reasons why one may accept a compromised practice profit, consideration should be given to all ramifications. Dr. Older is not alone. There are many mature veterinarians who are cruising to an unforeseen retirement crisis.