

Strategies for More Tax-Effective Physician Acquisition Transactions

a presentation for

American Health Lawyers Association's
Tax Issues for Health Care Organizations

October 21-22, 2013

Ritz Carlton, Pentagon City

Susan Clark, CPA
Pershing Yoakley & Associates, P.C.
sclark@pyapc.com
(865) 673-0844

Michael F. Schaff, Esq.
Wilentz, Goldman & Spitzer, P.A.
mschaff@wilentz.com
(732) 855-6047

Agenda

Physician Practice Acquisitions

Regulatory and Legal Considerations

Overview of Personal and Enterprise Goodwill

Practice Acquisitions Involving Personal Goodwill

Valuing Personal Goodwill

Hypothetical Transaction

Current Trends in Physician Practice Acquisitions



Physician medical group transactions have increased significantly in number and dollar value since 2009.



Hospitals are active acquirers, but recent trend involves combination of physician practices with range of other complementary practices:¹

- Healthcare Partners acquisition by DaVita (kidney care services).
- Walgreens' partnering w/physician practices to form ACOs.
- BCBS of Florida acquisition of Diagnostic Clinic Management Group.



Private equity firms also actively looking for opportunities to acquire. Private equity firms are very active in purchasing **medical practices** in various specialties, including anesthesia, radiology, urgent care, ambulatory surgery, and others.

¹ Avondale Partners, "Physician Practice M&A: Not Just for Hospitals Anymore", May 30, 2013.

Practice Acquisition Drivers



From the buying Hospital perspective:

- Regulatory considerations / changes in law
- Ability to stabilize supply of physicians in the market and reduce costs associated with turnover; address physician shortages
- Ability to address call coverage challenges
- Opportunity to capture patients and ancillary revenue in today's fee-for-service environment
- Improve quality of care provided in the outpatient setting; aligning on quality-of-care concerns and pay-for-performance initiatives

Practice Acquisition Drivers



From the selling Physician perspective:

- Declining reimbursement and, hence, incomes; increasing debts
- Changing physician demographics; better work / life balance
- Fewer administrative responsibilities
- More predictable compensation
- Access to employer expertise and resources (IT; medical malpractice; purchasing; regulatory compliance)
- Access to capital
- Access to broader range of employment benefits

Transaction Considerations

- The hospital and physician practice should be a good fit strategically
- Regulatory restrictions (e.g., Commercial Reasonableness and FMV)
- Deal structure
- Post-transaction governance
- Keeping the physicians engaged and motivated
- Ancillary services – impact on compensation
- Due diligence

Transaction Options



Is the deal an asset or stock/membership purchase?

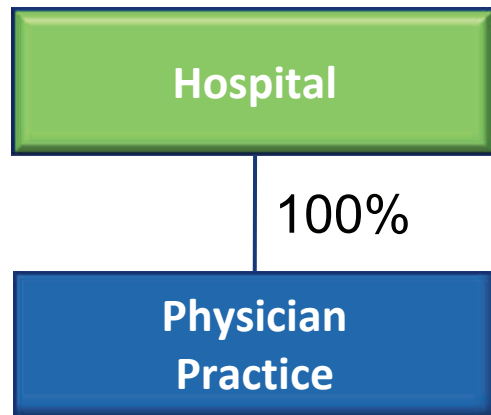
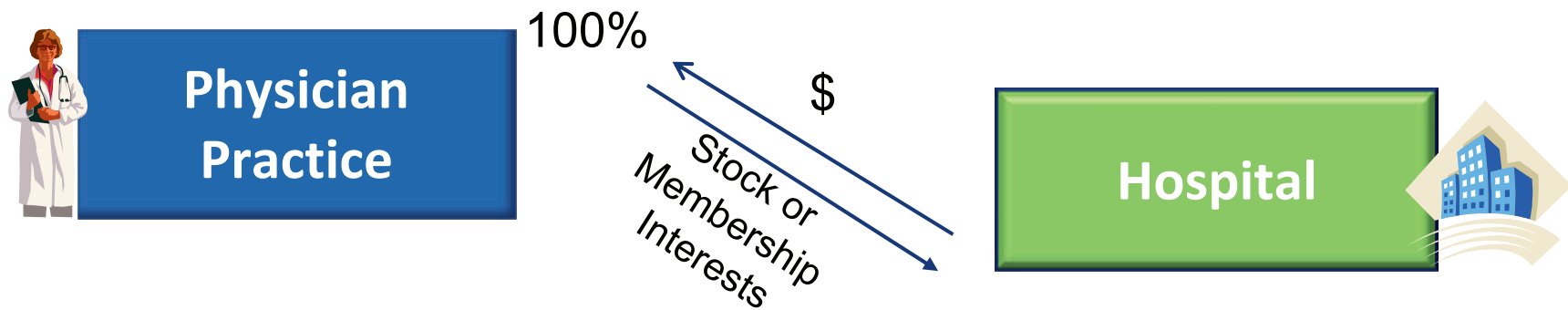
- Most practice acquisitions are structured as asset purchases.



Tax consequences for buyer and seller can be key determinant as to whether a transaction is completed:

- Sellers prefer ***stock or membership sale***
 - Avoid double taxation (corporate and individual)
 - May not need landlord and other consents for transfer
- Most buyers prefer ***asset purchases***
 - Step-up in tax basis of assets, resulting in lower taxes
 - Can amortize goodwill, among other intangibles, over a 15-year period
 - Avoid inheritance of any contingent liabilities

Stock or Membership Acquisition Structure



Structuring Options

- Subsidiaries of For-Profit Organizations
- Conversion to Tax-Exempt Entities
- Subsidiaries of Tax-Exempt Hospitals

Stock or Membership Acquisition Structure



From the buying Hospital perspective:

- Transfers entire practice (including: all assets, employees, real estate)
- Hospital assumes responsibility of all known / unknown / future liabilities
- Not necessary to re-title assets
- Obtain selling company's non-assignable contracts, permits, and licenses without the consent of the other party
- Physician practice's employer identification number remains in tact

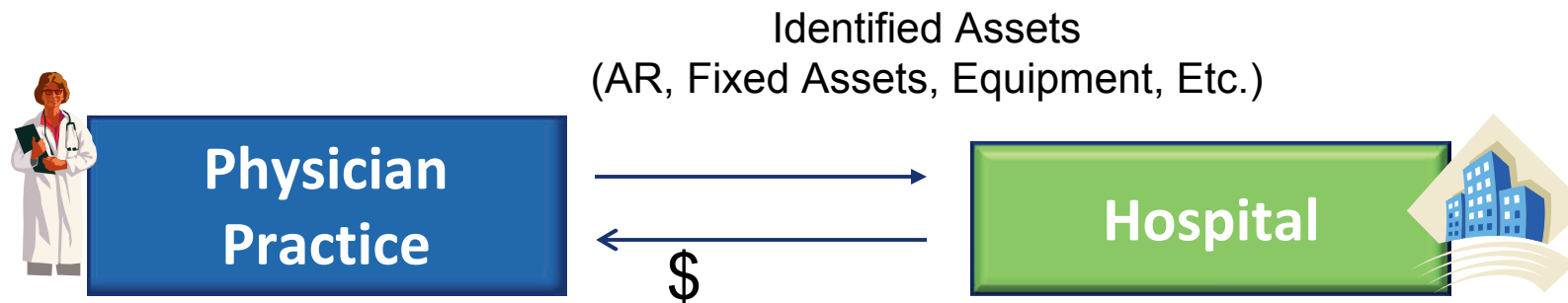
Stock or Membership Acquisition Structure



From the selling Physician Practice perspective:

- Stock acquisition is often preferred by sellers because proceeds taxed at capital gains rate
- Closing may be simpler and faster
- May not need re-credentialing with managed care plans
- In states that have bulk sale notification requirement, may be able to avoid

Asset Acquisition Structure



Structuring Options

- New subsidiary formed to hold assets (for profit or tax-exempt)
- Single Member Limited Liability Company
- Assets integrated into existing organization

Asset Acquisition Structure



From the buying Hospital perspective:

- Purchase of selling company's assets: facilities, equipment, inventory, etc.
- Purchase price > aggregate tax basis = stepped-up basis
- Depreciable assets written off in future fiscal years
- Goodwill may be amortized for tax purposes over a period of 15 years
- Ability to limit assumed liabilities
- May need to re-title assets
- Third party consents for assignments of certain contracts (leases, employees, business relationships)

Asset Acquisition Structure



From the selling Physician Practice perspective:

- Generally involves sale by corporation of some or all assets and then liquidation of corporation with distributions to shareholders
- Double tax situation
- Built-in gains
- Ability to sell less than all the assets
- Enterprise vs. personal goodwill

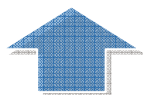
Navigating the Health Care Regulatory Environment

STARK LAW



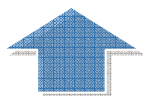
Prohibited self-referrals for Medicare and Medicaid patients.

ANTI-KICKBACK STATUTE



Knowingly and willful offers, payments, or receipts for referrals.

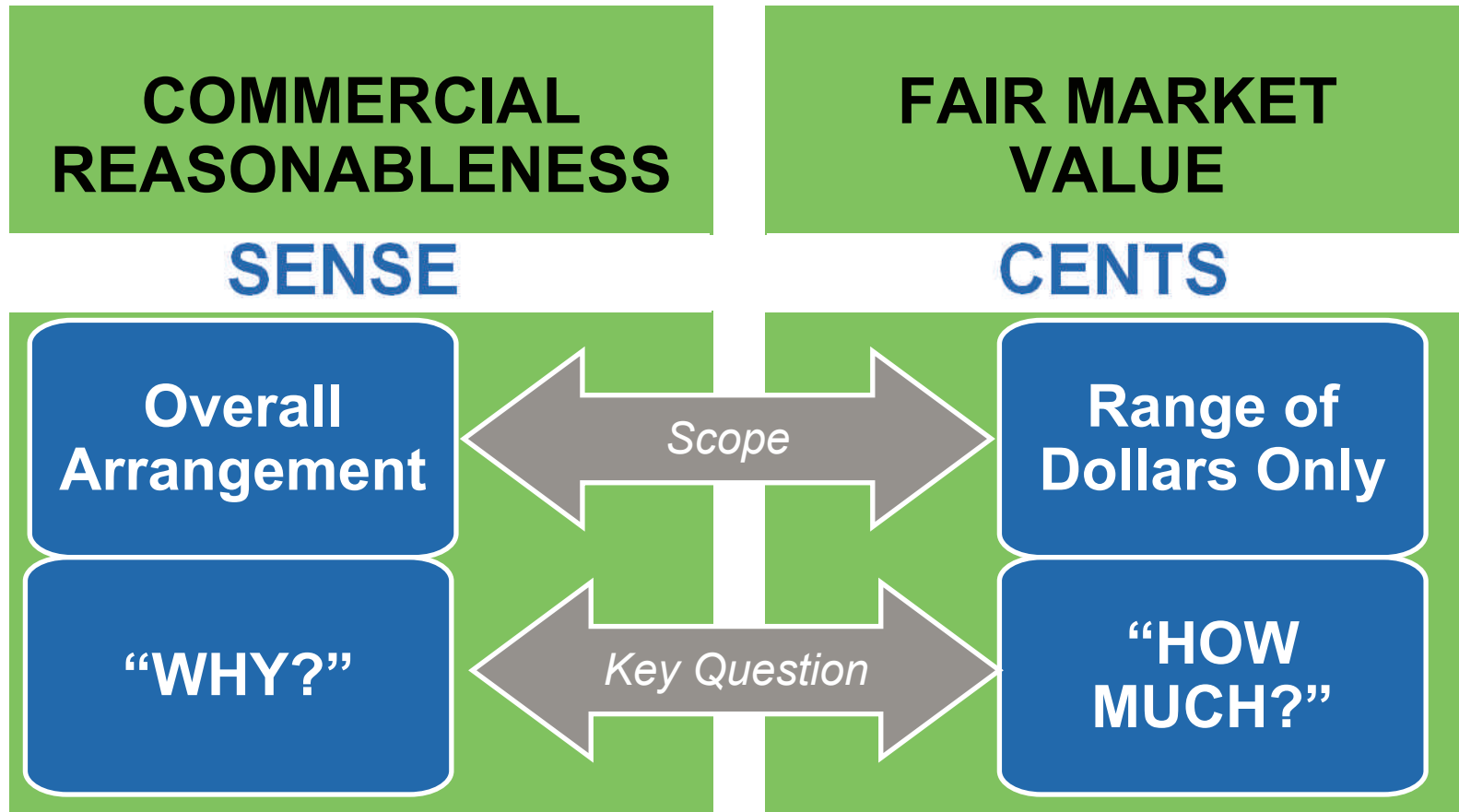
OTHER



- State laws
- Healthcare regulatory environment



Compliance Issues



Commercial Reasonableness

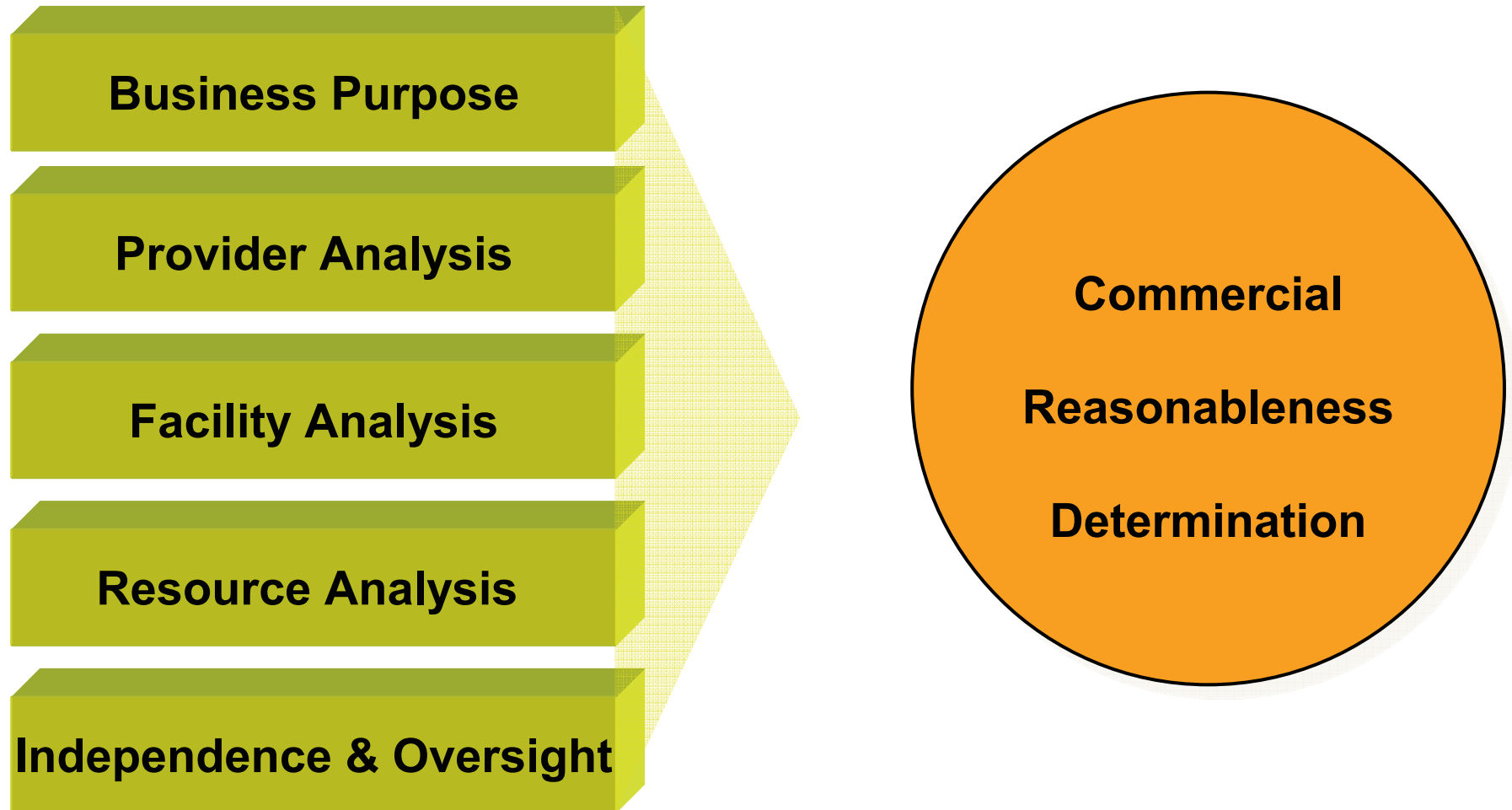
- **Department of Health and Human Services Definition¹**
 - An arrangement which appears to be “a sensible, prudent business agreement, from the perspective of the particular parties involved, even in the absence of any potential referrals.”
- **Stark Definition²**
 - “An arrangement will be considered ‘commercially reasonable’ in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician of similar scope and specialty, even if there were no potential designated health services (“DHS”) referrals.”
- **OIG Threshold³**
 - Compensation arrangements with physicians should be “reasonable and necessary.”

¹63 Fed. Reg. 1700 (Jan. 9, 1998).

²69 Fed. Reg. 16093 (Mar. 26, 2004).

³“OIG Compliance Program for Individual and Small Group Physician Practices,” Notice, 65 Fed. Reg. 59434 (Oct. 5, 2000);
OIG Advisory Opinion No. 07-10, September 2011, 2007, pg. 6, 10; “OIG Supplemental Compliance Program Guidance for
Hospitals,” Notice, 70 Fed. Reg. 4858 (Jan. 31, 2005).

Commercial Reasonableness Factors



Fair Market Value

- **IRS Definition¹**

- Fair market value (“FMV”) is defined as the amount at which property would change hands between a willing seller and a willing buyer when neither is under compulsion and both have reasonable knowledge of the relevant facts.

- **OIG/Stark Definition²**

- The value in arm’s-length transactions, consistent with the general market value.
- The price that an asset would bring as the result of *bona fide* bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of *bona fide* bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement.

¹Estate Tax Reg. 20.2031-1-1(b); Revenue Ruling 59-60, 1959-1, C.D. 237.

²Federal Register / Vol. 69, No. 59 / Friday, March 26, 2004 / Rules and Regulations.

Corporate Practice of Medicine Doctrine

State-by-State

Prohibits a business corporation from practicing medicine or employing a physician to provide professional medical services

Exceptions vary (e.g., nonprofit corporation, hospitals, hospital affiliates, universities, HMOs)

Workarounds include medical foundation and captive or friendly PC models

Valuation Methodologies Typically Used for Physician Practices

- **Asset (“cost”) Approach**

- Derives an indication of value based on the anticipated cost to replace, replicate, or recreate the asset.
- Often considered a “floor” value.
- Net Asset Value Method

- **Income Approach**

- Based on the entity’s earning power (i.e. ability to generate positive cash flow in excess of the physician’s fair market value compensation).
- Primary methods include:
 - Discounted Cash Flow Method
 - Capitalized Income Method

Valuation Methodologies Typically Not Used for Physician Practices

- **Market Approach** – determines an indication of value based multiples derived from similar businesses/interests that have been bought/sold
 - Guideline Public Company Method
 - Merger and Acquisition Transaction Data Method
- **Normally not used for physician practices because:**
 - No publicly-traded physician practices
 - Lack of reliable transaction data involving practices that are sufficiently similar

Which Method is Appropriate?

IT DEPENDS...

***If the
Practice...***

...has intangible
value (such as
goodwill),
an income
approach will
probably be
required

...does not
have intangible
value,
the NAV
method
should be
used

Allocation of Purchase Price



In an acquisition structured as asset deal (for tax purposes), buyer and seller must allocate purchase price to assets bought/sold:

- Value of intangible assets (including goodwill) is driven by a market advantage giving rise to “excess earnings”, or earnings in excess of normal returns on business’s operating assets.
- Requires consideration of the existence of goodwill and, in turn, the presence of **personal and/or enterprise goodwill**.

Enterprise vs. Intangible Value

- **The sum total of the tangible and intangible assets can not exceed the entity's total enterprise value!**
- **Example:**
 - If the enterprise value = \$2 million (e.g. determined from DCF Method)
 - And the tangible assets (e.g. cash, accounts receivable, equipment, etc.) = \$1,200,000
 - Then, (with limited exceptions) intangible assets can not exceed \$800,000

Assessing Intangible Value

 Determining the existence of physician practice intangible value (within the limitations of FMV primarily based upon cash flow

 If intangible value exists, there should be an economic benefit of ownership (i.e., in excess of FMV compensation)

 Positive cash flow = some level of intangible value

 Neutral/Negative cash flow = little or no intangible value

Certain Practices Are More Likely to Have Intangible Value

Large multi-specialty practices with mid-level providers and/or significant ancillary services are more likely to have intangible value because they generate revenue in excess of the physician's personal efforts

Small highly specialized practices (e.g., general surgeons) are less likely to have intangible value because substantially all revenue is professional fees generated by the physician(s)



Personal v. Enterprise Goodwill



Personal Goodwill:

- A personal asset that depends on the continued presence of a particular individual and may be attributed to the individual owner's personal skill, training or reputation.¹



Enterprise Goodwill:

- An asset of the business and may be attributed to a business by virtue of its existing arrangements with supplies, customers or others, and its anticipated future customer base due to factors attributable to the business.¹



Non-transferable Goodwill:

- In cases where the business generates income for the individual, but little beyond the efforts of that person, the goodwill is generally not transferable.

¹ *Supreme Court of Appeals of West Virginia, May v. May, (No. 31123)*

Personal Goodwill



Characteristics of Personal (or Professional) Goodwill:

- Existence is based on the fact that people come to the individual. Assumption is if individual were not there, the clients would go elsewhere.¹
- May be based on individual's skills, knowledge, reputation, personality, business relationships, and other factors.¹
- Often applicable in businesses that are technical, specialized, or professional, or have few customers or suppliers, such as medical practices.
- No non-compete exists between selling shareholder or member and company.

¹ BVR's Guide to Personal v. Enterprise Goodwill, 2009 Edition.

Enterprise Goodwill



Characteristics of Enterprise (or Practice) Goodwill:

- Existence is based on the fact that people come to the enterprise.¹
- Loss of key individuals would not materially impact company.
- May be based on location, staff, website, facilities, and reputation/brand of the entity (as opposed to an individual's reputation).¹ Sales generated from company sales team.
- Applicable for larger businesses with formal organizational structure, processes, and controls, diversified customer base, deep management team and/or long-term customer contracts.
- Common with businesses that are more asset intensive.
- Non-compete exists between selling shareholder or member and company.

¹ BVR's *Guide to Personal v. Enterprise Goodwill*, 2009 Edition.

Tax Attributes/Benefits of Personal Goodwill



If personal goodwill is believed to exist, structuring the transaction with **separate purchase agreements** for the business and for the shareholder's personal goodwill may produce tax benefits:

- Buyer may be entitled to amortization deductions for the personal goodwill under IRC Section 197.
- **Does not trigger entity-level gain on the sale of personal goodwill.**
- Seller's gain from sale of personal goodwill is taxed at capital gains tax rate.
- Depending on the tax structure of the buyer (for-profit status, nonpublic versus public company), other benefits may exist with regard to accounting for the transaction.

Transfer of Personal Goodwill



When considering whether personal goodwill in a particular acquisition can be transferred to the buyer, one is really asking “**can the personal goodwill be converted into enterprise goodwill?**”

- Possibly, depending on form of personal goodwill, consideration of facts and circumstances, and through effective internal controls and contractual obligations.

- Forms of personal goodwill include:

- **Relationships**
- **Skill**
- **Knowledge**
- **Reputation**

Acquisitions with Personal Goodwill

Structuring the Transaction



The sale of personal goodwill should not be a tax afterthought. It must be planned in advance and be important to the seller. *Kennedy.*



Have separate sale of personal goodwill agreement that is signed in personal capacity. *Solomon v. Comm'r, 2008 Tax Ct. Memo LEXIS 107 (Apr. 16, 2008).*



Have employment agreement with purchasing corporation as evidence that the individual taxpayer is taking steps to transfer the personal goodwill. *Muskat v. United States, 2008 U.S. Dist. LEXIS 29674 (D.N.H. Apr. 2, 2008); Solomon.*



Also typical for seller of personal goodwill to enter non-compete with purchaser.

○ Can be evidence of transfer of personal goodwill. Payment for non-compete is ordinary income, going back to allocation of purchase price.

Court Cases - Taxpayer Wins



Martin Ice Cream v. Commissioner (1998)

- Ruled MIC was not required to recognize gain as it was not the owner of assets sold; SIC was. Assets were personal to Arnold and were intangible relationships with supermarket owners. Arnold's personal goodwill was sold, which was never owned by SIC/MIC.
- Key to decision was **absence of non-compete agreement between Arnold and MIC or SIC**. Having never transferred Arnold's expertise or relationships, they remained his personal assets.



Norwalk v. Commissioner (1998)

- Court ruled in favor of shareholders, stating it was “the personal ability, personality, and reputation...clients sought.”
- Key to decision were expiry of non-compete agreements**, that if shareholders left corporation, clients would follow, and court attributed no value to the business independent of accountants themselves.

Court Cases - Taxpayer Losses



Solomon v. Commissioner (2008)

–Court noted nothing in agreement referenced sale of personal goodwill. Value of company was not attributable to service or relationships of the Solomon's, and because it was not service business, it did not depend on owners for success.

–Although sellers had non-competes, they **did not sign consulting or employment agreements, so that personal attributes were not available to buyer after sale.**

Concluded the proceeds paid directly to shareholders were attributable to non-competes rather than customer list or personal goodwill.



Kennedy v. Commissioner (2010)

–Court believed payment for providing ongoing services could be considered goodwill; however, in this case, believed payments were for services, not for personal goodwill.

–Alluded to support for existence of personal goodwill - to extent contractual allocation of personal goodwill reflects relative value of customer relationships from value of seller's ongoing services and economic reality, may be greater chance of taxpayer success.

Favorable Items for Consideration



Individual taxpayer possesses unique skills and personal relationships. *Robert W. Wood, The Emperor of Ice Cream, Dentists, and Personal Goodwill, TAX NOTES TODAY, Nov. 15, 2010.*



Examples:

- Offered a job because of relationships developed. *Martin Ice Cream.*
- Clients would follow the employee if he left. *Norwalk.*
- Has a reputation in the industry or community for being the “go to guy.” *H&M v. Comm’r, T.C. Memo 2012-290 (2012).*

Hypothetical Transaction

Surgery Center of America, P.A.



Surgery Center of America, P.A.

- Background information:

- An ambulatory surgery center, **Surgery Center of America, P.A. ("SCA")**, is owned 100% by Dr. Beverly Smith. SCA is a C Corp.
- **Dr. Smith sells the practice** in an asset sale (excluding A/R and liabilities) to a third-party **for \$5 million**, on December 31, 2013.
- The fair market value of identifiable tangible and intangible assets is \$1.3 million, with **\$3.7 million attributed to goodwill**.



How does the categorization of goodwill as Dr. Smith's personal goodwill affect Dr. Smith's after-tax proceeds?

Hypothetical Transaction

Pre- & Post-Acquisition Accounting

Pre-Acquisition Balance Sheet December 31, 2013

Cash	\$ -
Accounts receivable	700,000
Inventory	<u>400,000</u>
Current Assets	1,100,000
Net fixed assets	150,000
Intangible assets	-
Other assets	<u>-</u>
Total assets	<u>\$ 1,250,000</u>
Current liabilities	\$ 700,000
Long-term liabilities	<u>-</u>
Total liabilities	700,000
Equity	<u>550,000</u>
Total liabilities and equity	<u>\$ 1,250,000</u>

Post-Acquisition Purchase Price Allocation January 1, 2014

Cash	\$ -
Accounts receivable	-
Inventory	400,000
Less: liabilities assumed	<u>-</u>
Working capital purchased	400,000
Net fixed assets	300,000
Medical records	600,000
<i>Goodwill</i>	<i>3,700,000</i>
Total assets*	<u>\$ 5,000,000</u>

** Total sales price of \$5 million, excluding accounts receivable and current liabilities.*

Hypothetical Transaction

Scenario 1: *All Goodwill is Enterprise*

Corporate Level

	Cash	Tax
Sales proceeds	\$ 5,000,000	\$ 5,000,000
Less: Basis of assets		(550,000)
Gain before tax		4,450,000
Estimated Federal tax liability (35%) ¹	(1,557,500)	\$ 1,557,500
Net cash before individual tax	\$ 3,442,500	

Individual Level

	Cash	Tax
Corporate cash proceeds	\$ 3,442,500	\$ 3,442,500
Less: Basis in stock		-
Capital Gain		3,442,500
Tax on capital gain (23.8%) ²	(819,315)	\$ 819,315
Net cash proceeds	\$ 2,623,185	

Summary of Proceeds

Sales proceeds	\$ 5,000,000
Less: Federal corporate taxes	(1,557,500)
Less: Capital gains tax	(819,315)
Net cash proceeds (individual)	\$ 2,623,185

¹ Federal tax assumed at 35% rate for personal service corporations. State tax is disregarded for ease of illustration.

² Capital gains rate assumed at 23.8% (20% rate for individual income greater than \$450,000 plus an additional 3.8% unearned income Medicare tax).

Hypothetical Transaction

Scenario 2: *All Goodwill is Personal*

Corporate Level

	Cash	Tax
Sales proceeds	\$ 5,000,000	\$ 5,000,000
<i>Less: Personal goodwill</i>	(3,700,000)	(3,700,000)
Less: Basis of assets		<u>(550,000)</u>
Gain before tax		750,000
Estimated Federal tax liability (35%) ¹	<u>(262,500)</u>	\$ 262,500
Net cash before individual tax	\$ 1,037,500	

Individual Level

	Cash	Tax
Corporate cash proceeds	\$ 1,037,500	\$ 1,037,500
<i>Add: Personal goodwill</i>	<u>3,700,000</u>	<u>3,700,000</u>
Subtotal	\$ 4,737,500	\$ 4,737,500
Less: Basis in stock		<u>-</u>
Capital Gain		4,737,500
Tax on capital gain (23.8%) ²	<u>(1,127,525)</u>	\$ 1,127,525
Net cash proceeds	\$ 3,609,975	

Summary of Proceeds

Sales proceeds	\$ 5,000,000
Less: Federal corporate taxes	(262,500)
Less: Capital gains tax	<u>(1,127,525)</u>
Net cash proceeds (individual)	\$ 3,609,975

¹ Federal tax assumed at 35% rate for personal service corporations. State tax is disregarded for ease of illustration.

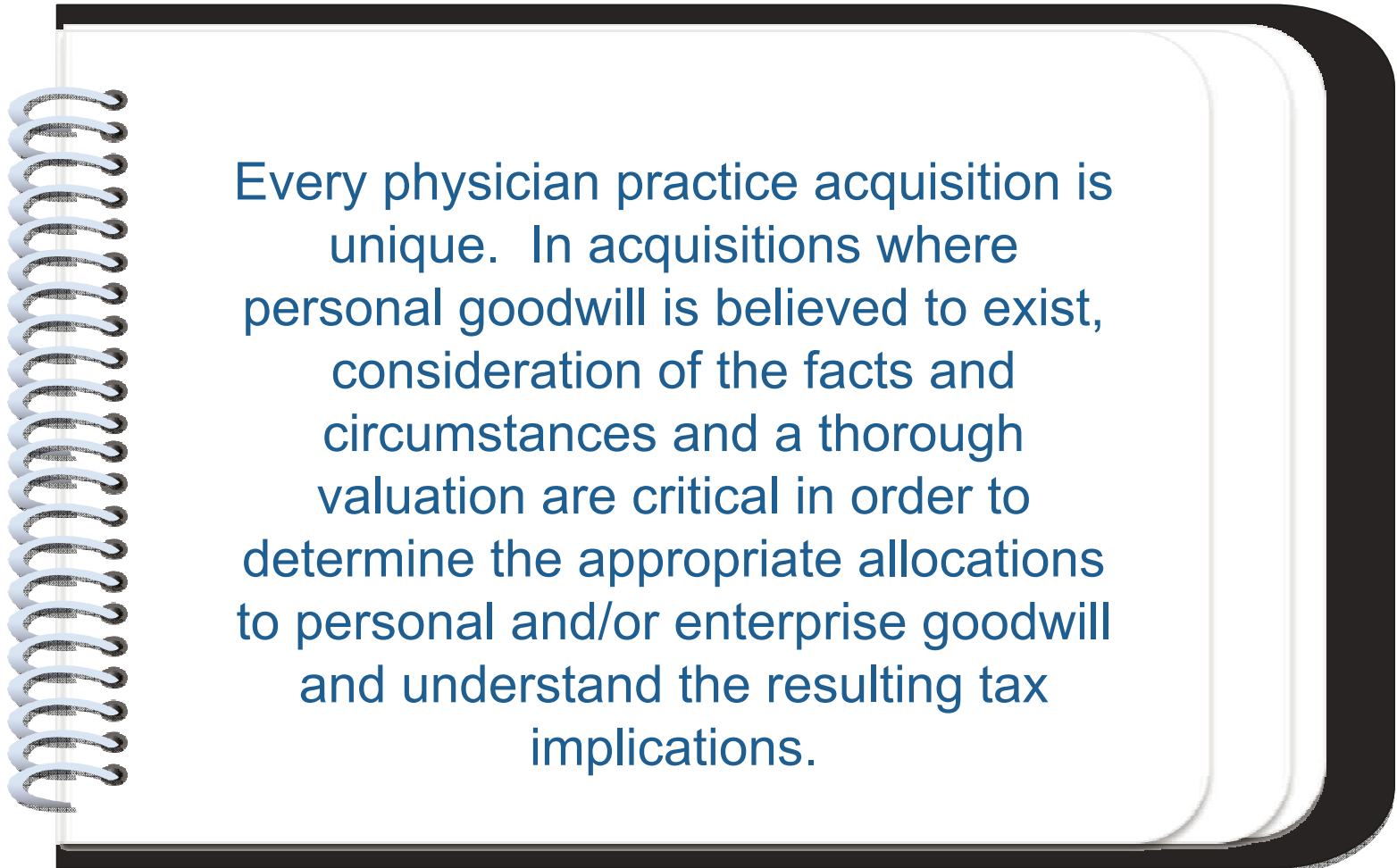
² Capital gains rate assumed at 23.8% (20% rate for individual income greater than \$450,000 plus an additional 3.8% unearned income Medicare tax).

Hypothetical Transaction

Entity Type: What if S Corp?

- Tax calculations will differ based on type of entity of the seller
- C Corporations: Corporation pays tax on any gain realized from the sale of assets based on sale price of the assets over the corporation's basis in the assets. Taxable income is recognized by the shareholders on the distribution from the corporation following the sale. Individual tax is based on the difference between the distribution amount and the shareholders' basis at capital gain rates.
- Pass-through Entities: Corporate level gain flows through to the shareholders or members maintaining the corporate characteristics (e.g. capital gain or ordinary income). No tax is generally due on liquidation because basis in stock or membership interest is increased by the gain recognized. Built-in gain recognition is required in certain situations.

Summary

A graphic of a spiral-bound notebook with a white cover and a silver spiral binding on the left side. The notebook is open, showing several pages. The text is written on the top page in a blue, sans-serif font.

Every physician practice acquisition is unique. In acquisitions where personal goodwill is believed to exist, consideration of the facts and circumstances and a thorough valuation are critical in order to determine the appropriate allocations to personal and/or enterprise goodwill and understand the resulting tax implications.

Contact Information

Susan Clark, CPA

Pershing Yoakley & Associates, P.C.

sclark@pyapc.com

865.673.0844

Michael F. Schaff, Esq.

Wilentz, Goldman & Spitzer

mschaff@wilentz.com

732.636.8000