Handling Ancillary Businesses: ASC, Optical, Real Estate and Others

Daniel M. Bernick, Esquire, MBA*
Mark E. Kropiewnicki, Esquire, LLM*

The Health Care Group ®
Plymouth Meeting, PA

www.healthcaregroup.com

* Financial Interest

Financial Interest Disclosure

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Who We Are

- Business and legal advisors to physicians
- Publishers of the Goodwill Registry, used in valuation of ophthalmology and other medical practices
- Handle and advise re: practice buy-ins, buy-outs, sales, mergers and valuations
The Businesses

- ASC
- Optical
- Real estate
- Equipment
- Management services

Topics

- Incorporate separately?
- Permit non-physician or outside ownership?
- Buy-sell valuation formulas
- Accounting, tax, legal considerations
- Reimbursement issues

The Entities

- Corporations
- Limited liability companies
- Other: general partnership, limited partnership
Potential Benefits of Separate Entities

- Need to bring in outside investors – E.g., other surgeons, for ASC
- Want to give equity or profit share to non-physicians – e.g. optical shop stock to Ods
- Not everyone wants to invest in ancillary business – e.g., real estate

Other Benefits

- Bifurcate buy-in process (e.g., first medical practice, then ASC)
- Local payor reimbursement preferences
- Accounting/business management
  - Force rigorous cost accounting

Taxes

- May need an S corp or LLC “pass-through” type entity for ancillary business
  - e.g., real property – avoid trapping appreciation in corp, double tax
- May be state tax implications, e.g., state corporate net income or franchise taxes
More Factors

- Asset Protection
  - E.g. spouse owns portion of real estate
- Estate planning
  - Trusts for kids (e.g., real estate, equipment partnership)

Costs of Separate Entities

- Extra tax returns, financial statements ➔ accounting fees
- Extra legal documents ➔ legal fees
- Cost allocation ➔ administrator time
- More entities to credential with payors
- Complexity ➔ more to think about

Other Factors

- Separate entity will likely require pro-rata allocation of profit
  - 20% equity share equals 20% share of profit
  - Cannot reflect “productivity” or referral patterns
- Single entity
  - More leeway to reflect ancillary “productivity” via manipulation of W-2 wages to doctors
Other Factors

• Separate entity may not be permitted, legally
  • E.g. Stark does not permit separate “testing” entity – tests must be part of core PC
  • State “mini-Stark” or fee splitting rules may be triggered by separate entity

Primer on Choice of Entity

• Core medical practice is generally either a professional corporation (PC)
  • or limited liability company (LLC) or professional LLC (PLLC)
• PCs and PLLCs: ownership is generally limited to physicians
  • Sometimes, licensed ODs may be co-owners – depends on state law
  • Why they are called “professional” entities

Non-Professional Entities

• Ancillary entities generally do not need to be “professional”
  • “Business” corporation instead of “professional” corporation
  • “LLC” versus “PLLC”
• Non-professionals may be owners
  • ASCs, optical shops, real estate, equipment partnerships, management service companies
"C" corps, "S corps"

- "C" versus "S" is a federal tax election made by corporations, including PCs
- "C" corporations are subject to federal income tax
  - Why you pay year end bonuses, to eliminate taxable profit
  - Eliminate the "double tax"

"C" corps, "S corps"

- "S" corps are "passthroughs"
  - No corporate level tax
  - Any entity level profit "flows through" directly to shareholders
- PLLCs and LLCs are also passthroughs

So why form a "C" corp?

- For older corps, there used to be special tax advantages for a C corp
- Also, S corps are subject to special restrictions
  - E.g., can't have more than one class of stock
Choice of Entity Drivers

- Taxes: federal and state
  - Taxation of yearly operating income
    - E.g. state corporate taxes
  - Shareholders in a corporation get W-2s
  - Members of an LLC get K-1s
  - Transition tax costs
    - When "C" corp converts to "S" status
    - When C or S corp converts to LLC

Choice of Entity Drivers

- Advisor preference is important
  - Your accountant and attorney will generally prefer one type of entity to another
  - For tax reasons
  - For ease of working with legal documentation and legal issues

Other Entities

- General partnerships
  - Offer no liability protection
    - Slip and fall in office
    - Each partner is personally liable for malpractice of his partners
    - Each partner is personally liable for acts of the partnership
    - Consequently, rarely used
  - Sole proprietorships – no entity protection
Other Entities

- Limited partnerships and limited liability partnerships
  - The old pass-through vehicles
  - Some liability protection
  - But not as much as the newer LLC format
- But remember
  - You are always fully liable for your personal acts and omissions, as a doctor
  - Why you have malpractice insurance

Coordination of Entities

- Consider mirror image ownership percentages in ancillary entities
- These keeps the core shareholders “on the same page”
  - No conflicts of interest
- Example: a new shareholder offered 25% of PC would also be able to buy 25% of ASC or optical shop

Coordination of Entities

- Similarly, on buy-out side, require a shareholder who is giving up his PC stock due to retirement to also sell his ASC or optical shop shares
- Preserves mirror-image ownership ratios
Agreements Between Entities

- Medical practice will have lease with real estate entity, for use of space
- Medical practice may have management agreement with ASC or optical entity, with cost allocation provisions

ASC

- Can be part of medical PC, or a separate entity

Reasons to do separately

- Allows investment by outside surgeons, at a later date
- Permits limiting investment to surgeons, versus medical opthalmologists
- Permits two step buy-in – medical practice now, ASC later
- Tax advantages – sale of equity to new investor is mostly capital gain to seller
**Reasons to do Separately**

- Tax advantages – sale of equity to new investor is mostly capital gain to seller
  - No pre-tax income shifts are used in buy-in
  - Compare with medical PC
    - Pre-tax income shift is significant portion of buy-in structure

**Any reasons not to do separately?**

- Added accounting fees (more tax returns) and legal fees (more documents)
- More flexibility in allocation of profits, if everything is in main PC or LLC
- Can do more of buy-in with pre-tax dollars (nice for new partner)

**ASC Choice of Entity**

- Typically LLCs or S corporations
  - Essential to have “pass-through” tax treatment
  - There is no opportunity to use W-2 bonuses to zero out C corp corporate income
ASCs

- First, consider valuation of medical PCs
  - Equipment: modified book value, or specially appraised
  - AR: collectible value
  - Goodwill: % of gross receipts
  - Add the individual components to derive total corporate value
  - Then multiply by % acquired (e.g. 20%)

Valuation of ASCs

- The PC valuation model may be appropriate if the ASC is part of the medical PC.
- But if separately incorporated, the ASC will often be valued differently: as a multiple of “earnings” or “EBITDA”: earnings before interest, taxes, depreciation, and amortization

Multiple of Earnings

- ASC Stock value is multiple of “EBITDA”
- E.g. new investor buys 20% for 20% times 3X earnings
- This includes all corporate assets: equipment, AR, goodwill
Multiple of Earnings

• A national surgery center developer such as Amsurg, Novamed, or USPI may pay 6-8x earnings
  • These multiples are paid for a majority (51%+) equity stake in a strong, multi-surgeon ASC
  • Doctor-to-doctor transactions are much lower: 2-4x earnings, maybe lower

ASC Valuation

• The final buy-in price to new investor in stand-alone ASC is paid 100% as stock purchase
  • No pre-tax income discounts

ASC Profit Sharing

• Pro-rata, based on percentage ownership
  • A 20% shareholder is entitled to 20% of profits
  • Cannot vary a shareholders’ profit % from year to year, based on case volume
  • If a shareholder wants more of the profit, he must buy more shares, from another shareholder (who may not want to sell!)
  • Once set, stock %s remain fixed indefinitely
Major ASC Issues

- Compliance with federal anti-kickback “safe harbors”
  - Not required, but desirable (safer) if you comply
  - Affects buy-ins and buy-outs

Safe Harbor Compliance

- The terms offered to a new investor must not be related to expected volume of referrals
  - i.e., heavily discounted purchase price to induce purchase by “heavy hitter” surgeon
  - Careful offering a multiple to buy in which is less than that to buy-out

Safe Harbor Compliance

- New investor must not borrow the purchase price from the ASC or existing investors
  - He must pay cash, e.g., with financing from a bank
ASC Non-Competes

• Legally, the ASC may not require its shareholders to do all or any of their cases at the ASC
  • This would be a kickback problem
  • And possibly conflict with patient’s best interest

ASC Non-Competes

• But the ASC may bar its shareholders from owning interests in competitive ASCs
  • This is legal
  • And it ensures that most cases done by the shareholders will be done at the ASC
  • Morale of the story: pick your ASC carefully - you won’t get to invest in more than one

Optical Shop

• Should there be a separate entity?
• Reasons can include:
  • Want ODs or opticians to have small equity stake
  • Want to value optical shop differently from medical practice
Optical Shop

• Most ophthalmologist owned optical shops are not separately incorporated
• Reasons for separate incorporation are less compelling than in ASC
  • Optical shops are never co-owned with competing ophthalmologists (compare ASCs)
  • No Amsurg or USPI is out there waiting to buy an interest

Optical Shop

• Other considerations re: separate optical entity:
  • Optical shop may have no true independent value apart from the referring medical PC
  • A separate optical shop must be separately credentialed with payors

Optical Shop

• If you do separately incorporate:
  • Use a “passthrough” : S corp or LLC
  • Consider mirror image ownership with PC
  • Include buy-out trigger: if shareholder sells his PC stock, he must also sell his optical shares
Optical Shop Valuation

- If part of medical practice, its assets are simply part of the overall valuation
  - Optical equipment part of total equipment
  - Optical AR part of total AR
  - Optical goodwill part of overall goodwill

Optical Shop Valuation

- If separately incorporated, you can use the same formula as PC (equipment, AR, goodwill)
  - But all values are incorporated into stock
  - No “severance” or “deferred comp”
  - Could do a “multiple of earnings approach”
    - But question whether this is appropriate

Real Estate

- Should definitely be a separate entity, not in PC
  - Valuation, accounting are different from PC
  - Need to use a pure passthrough entity, preferably LLC (better than S corp)
Real Estate

- Mirror-image ownership vs medical PC is very desirable, for the usual reasons
  - Eliminates conflicts of interest
  - Such as amount of rent to be charged to PC
- Use buy-out triggers to force retiring physician to give up equity in real estate, along with PC equity

Real Estate Valuation

- Valuation is by special appraisal, at "fair market value", done at time of buy-in and at buy-out
- If departing partner does not like the partnership's appraisal, he can commission his own appraisal
- Then need to reconcile the competing appraisals

Other Entities

- Equipment leasing company
  - Buys equipment, leases to medical practice
- Management company
  - Owned by doctors with administrator
  - Administers medical practice for a fee
Other Entities

• Employee leasing company
  • Employs staff, leases to medical practice
• Is there a true business purpose? True need? (again: cost, complexity)
• If the entity has no independent source of business,

Other Entities

• The key question for these entities:
  • Do they have an independent source of business? (Other than the related medical practice.)
  • Is there a true business purpose?
  • Or just a tax motivation?
  • Consider the extra cost and hassle

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