Handling Ancillary Businesses: ASC, Optical, Real Estate, Equipment, Management Services

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* Financial Interest

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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
- Careful: don’t let tax “tail” wag business “dog”
More Factors

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

Separate Incorporation?

- Be clear on your objectives
  - There need to be good reasons for separate incorporation
  - There are extra costs

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

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**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

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**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"
    - i.e., the corporate level 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
  - No need to make an "S" election
  - Passthrough of profits is automatic
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 passthrough 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

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

Safe Harbor Compliance

- New investor must derive 1/3 of his professional income from surgery
  - Rules out medical ophthalmologist
  - Provides a fig-leaf for what surgeons want to do anyway – only sell shares to people who do surgery

ASC Hot Issues

- Getting out “non productive” doctors
  - Buyout triggers in shareholder agreement
    - Not meeting 1/3 test
    - Or not doing surgery
  - At a minimum, no doctor should be permitted to retain shares when he is no longer actively practicing medicine
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

Coordination of Entities

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

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
    - E.g. like an ASC, as a multiple of earnings

- 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

- More reasons not to separately incorporate
  - Optical shops have no true independent value apart from the referring medical PC
  - A separate optical shop must be separately credentialled with payors – more work

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?
  - Many of these entities seem to be tax motivated
  - Question whether worth the extra cost and hassle

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

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