

September 18, 2000

# RESTRUCTURING A PROFESSIONAL PRACTICE

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# RESTRUCTURING A PROFESSIONAL PRACTICE

## 1. ADVANTAGES.

The six (6) potential advantages include:

- 1.1. bringing other professionals into the practice;
- 1.2. preparing for the sale to a non-professional buyer (now common in the medical and accounting professions);
- 1.3. exit strategy for an aging professional while preserving a continuing economic interest;
- 1.4. giving some assets a higher degree of protection from frivolous claims;
- 1.5. gaining another pension plan;
- 1.6. deferring some income to a future year; and
- 1.7. shifting income from your 39.6% Federal tax bracket to an age 14 or older child's 15% bracket.

## 2. TYPICAL RESTRUCTURING.

Form the new entity, transfer the assets and then prepare the contracts.

### 2.1. Alternative #1.

Form a non-professional corporation ("NPC"); the professional corp. ("PC") transfers assets to it; and then the NPC contracts with the PC.

## **2.2. Alternative #2.**

Convert the existing PC to an NPC and establish a new PC.

Advantage over Alternative #1: should avoid complications and taxes arising from asset transfers required by Alternative #1.

Disadvantage compared to Alternative #1: the NPC continues to be exposed for old (pre-conversion) malpractice claims.

## **2.3. Alternative #3 (CPAs Only):**

IDS (American Express) is buying CPA firms. That puts a deep pocket in front of the CPA for "malpractice" claims. That probably limits the CPA's exposure in ways that are not yet clear.

## **3. TRANSFER ASSETS.**

### **3.1. Tax Analysis Required.**

Depending upon which assets are:

- (i) to be protected; and
- (ii) needed,

you must carefully review the transfer's tax consequences.

For example, are the assets worth (net fair market value) the same as their net book value? If so, they can be transferred without triggering a taxable gain.

Also, consider transferring the accounts receivable as a loan, or not at all, to avoid immediate income recognition.

### **3.2. Anticipate Limit On MDs Referring.**

Assume X-ray equipment and technicians are in the NPC. Performance of X-rays by a NPC is a prohibited referral if the NPC is owned by the M.D. or family members. Assembly Bill 919 (Speier), regarding physician referrals, impacts the NPC. It would not prevent the transfer of assets. It affects referrals to or ownership of the NPC. However, the

NPC can still provide management services.

#### 4. **NPC CONTRACT WITH PC.**

##### 4.1. **What NPC Provides.**

The NPC can provide one or more of the following to the PC ("the Services"):

- ◆ billing and contracting;
- ◆ employees;
- ◆ facilities;
- ◆ financing;
- ◆ furniture, equipment and supplies; and
- ◆ advertising and marketing.

The list is, obviously, not exhaustive.

##### 4.2. **What PC Pays.**

A medical or accounting PC usually pays a fixed percentage of gross revenue for the services. A law PC may only pay for the reasonable value of the services actually provided.

Payment of a percentage of net by a medical PC is possible (see the excerpts from the prospectus of Pacific Physician Services, quoted below).

Bookkeeping may be the key problem in handling cash flow: timing payment of the management fee vs. the NPC's need to currently pay expenses.

##### 4.3. **Limits On Referrals Of Patients, Clients Or Customers.**

Any licensed professional's offer, delivery, receipt or acceptance of any rebate, refund, commission or other consideration as compensation or inducement for referring patients, clients or customers to any person is a criminal act.<sup>1</sup> Federal law similarly prohibits payments for referrals.

An early case held that a contract under which the hospital received 2/3rds and the radiologists received 1/3rd of **gross income** from fees for diagnostic services was not

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<sup>1</sup> Business & Professions Code §650.

illegal. The apportionment was commensurate with the expenses the hospital incurred in furnishing the facilities.<sup>2</sup>

By contrast, an agreement under which the hospital received 50% of the **net income** of the physician director of its EEG department was illegal.<sup>3</sup>

In either case, whether the contract is a percentage of gross or net, the compensation must be reasonable in light of the services provided.

#### **4.4. Compare Public Companies.**

##### **4.4.1. Percentage Of Gross.**

A 1984 prospectus<sup>4</sup> contained this language:

"Because California...prohibits the practice of medicine by a business corporation, the Company has entered into a Facilities, Leasing and Management Services Agreement...dated 4-26-84, with CMG, a California professional medical corporation....

...the Company leases or subleases to CMG the fully equipped Centers and performs all administrative and management services ...including providing repairs, security and maintenance for the Centers [and] manages the physical facilities and equipment of the Centers, hires and trains all non-physician personnel and provides billing services, appointment scheduling and similar services for the Centers' physicians.

...the Company retains administrators to supervise the management and administration of the Centers [and] is also responsible for obtaining all necessary insurance for the Centers other than medical malpractice insurance for the physicians.

...

In consideration for the premises, equipment and services furnished to CMG by the Company, CMG **pays 75% of its gross revenues** to the Company...subject to quarterly adjustment by mutual agreement...to reflect changes in staffing requirements and other labor costs, insurance costs, rental expense, taxes, and number of patients treated, and...changes

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<sup>2</sup> Blank v. Palo Alto-Stanford Hospital Center, 243 CA 2d 377 (1965).

<sup>3</sup> 55 Ops. Atty. Gen. 103 (3/3/72).

<sup>4</sup> U.S. Medical Enterprises, taken public by Wedbush, Noble, Cooke, Inc.

necessitated if national control of medical fees is implemented, PPO organizational expenses, the requirements of insurance companies and government agencies, seasonal or other significant economic business fluctuations [and] other factors determined...to be significant...."

#### **4.4.2. Percentage Of Net.**

Another prospectus<sup>5</sup> contained this language:

"The PPS network provides health care services in...California, which prohibits the corporate practice of medicine except by professional medical corporations. PPSMG [is] a professional medical corporation of which Dr. Groves is the [sole shareholder]."

"PPS has entered into the Management Agreement with PPSMG [delegating] to PPS administrative, management and support functions... required by PPSMG...physicians [to] practice... medicine. The PPSMG Management Agreement specifically obligates PPS to provide suitable facilities, fixtures and equipment, so that PPSMG can adequately provide for all medical services, and delegates to PPS those management and administrative functions which [are] not...the practice of medicine. PPS [must] provide to PPSMG administrative, accounting and billing services and non-physician support personnel (including nursing, marketing, clerical, administrative and maintenance personnel) and to assist in all phases of contract administration and marketing."

"Pursuant to the PPSMG Management Agreement, PPSMG has assigned to PPS all of PPSMG's rights and interest in **substantially all of the revenue** received by PPSMG. ...Amounts that may not be assigned to PPS under applicable law (including traditional-fee-for-service Medicare payments) and amounts received... with respect to medical centers that are managed by PPS but staffed by physicians not employed by PPSMG are not included in the revenue assigned to PPS by PPSMG. As compensation for services rendered to PPSMG by PPS under the PPSMG Management Agreement, PPS retains that portion of assigned revenue, net of allowances for uncollectible accounts, which equals (i) all of its costs, including indirect overhead expense relating to its ownership, management and non-physician staffing of the outpatient medical centers and (ii) 7% of such **net revenue**

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<sup>5</sup> 4/16/93 for Pacific Physician Services, Inc., by Furman Selz, Inc. and Lehman Brothers.

plus 50% of **net pretax income** to the extent it exceeds 7% of net revenue."

#### **4.5. Reduce Professional's Compensation For Professional Services.**

One goal of restructuring is to shift revenue, and ultimately value, from professional to NPC services. Therefore, the professionals should reduce their compensation from the PC to reflect the shift. They recover the rest from the NPC. That promotes equality of compensation in the PC among the professionals.

#### **4.6. Special Considerations For Medical Corporations.**

The Medical Board of California<sup>6</sup> is the principal state medical enforcement agency. It may, for example, suspend or revoke a physician's license. Therefore, only proper compensation should be paid the NPC.

Some agreements may be for a combination of a fixed minimum payment plus a percentage payable for variable services.

The relationship may not provide for the NPC to keep fees associated with ancillary services it provides not requiring an M.D., e.g., X-ray, laboratory, physical therapy. Federal and state laws prohibit self-referral. M.D.s need to keep the ancillary services in their own PCs.

Some agreements are structured to reduce management fees to preserve the minimum retention by the PC for professional salaries, or the NPC will advance funds (as part of fee or as a lien against accounts receivable) to provide the PC with a steady income level.

For Medicare, the contract must be in writing and at least 1 year long with a fixed fee structure based on reasonable value of services, i.e., not for goodwill = referrals. Fee cannot include premium for goodwill value that relates to the likelihood of patient referrals. Suggests you secure a 3rd party confirmation of the arrangement's reasonableness.

### **5. WHO OWNS THE NPC?**

The NPC is typically owned by an irrevocable trust for your children.

However, if you are attempting the difficult task of gaining a second pension plan, minor children will not be acceptable shareholders. See the discussion in item 11 below.

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<sup>6</sup> Formerly called the Board of Medical Quality Assurance.

If a sale of the NPC is likely, consider (i) using a "C" corporation, not an "S" corporation and (ii) transferring the stock to a charitable remainder trust.

### **5.1. What Does The Owner Get From The NPC.?**

The owner will be rewarded by receiving at least an annual stock dividend.

The owner need not be (i) employed by the NPC or (ii) a permissible signatory on its bank accounts.

### **5.2. Who Is Employed By The NPC?**

The answer depends upon the restructuring's goal.

If the goal is to gain protection from future frivolous plaintiffs, then the professional or the professional's spouse may be the NPC's employee.

Assume the goal is income-shifting from your 39.6% federal bracket to an age 14+ child's 15% bracket. The employee should, if possible, be a non-family member. See ¶11.2 below. Typically the NPC's employee will be one of the PC's current employees, e.g., the bookkeeper.

## **6. IS THE NPC AN "S" OR A "C"?**

### **6.1. "S" Corporation.**

Assume you will not qualify for a 2nd pension. Money should go from the NPC to your children without a corporate tax. Use an "S" corp. to avoid the extra level of tax, and have a trust for your children own the S corporation's stock (trust protects the stock from the children's creditors, e.g., ex-spouses).

### **6.2. Trusts As "S" Shareholders: In General.**

"S" corps can only have certain types of trusts as shareholders. The most important types for this purpose are (i) "qualifying Subchapter S trusts" ("QSSTs"); (ii) electing small business trust (ESBTs) and (iii) grantor trusts.

#### **6.2.1. QSSTs.**

QSSTs must have only one beneficiary, and the income must be distributed annually to the beneficiaries.

**Advantage:** The advantage is that the corporation's income is taxed to the shareholders. That permits income splitting - moving income from your 39.6% Federal bracket to an age 14+ child's 15% bracket.

**Disadvantages:**

#1: The requirement to annually distribute income is a disadvantage if, for non-tax reasons, you do not want children to have the money. The income can be taxed to the child, while you control the funds, by establishing a family limited partnership ("FLP" - see our separate handout describing the great estate planning benefits) and forcing the children to contribute the QSST income to an FLP in which the children are limited partners.

#2: The need for one QSST for each child.

**6.2.2. ESBTs.**

**Advantages:** An ESBT can have many beneficiaries. The trustee need not currently distribute income to the beneficiaries. Instead, income can accumulate for the beneficiaries' benefit.

**Disadvantage:** Trust income is not taxed at the children's potentially lower tax bracket. It is taxed in the trust's (higher) bracket.

**6.2.3. Grantor Trusts.**

**Advantages:** A grantor trust can have many beneficiaries. The trustee need not currently distribute income to the beneficiaries. Instead, income can accumulate for the beneficiaries' benefit.

**Disadvantage:** Trust income is not taxed at the children's potentially lower tax bracket. It is taxed in your bracket.

**6.3. "C" Corporation.**

Assume you want a 2nd pension. The corp. must be owned by someone (i) you trust who is (ii) not a "family member," e.g., a brother-in-law. You will not want the person you trust to pay the income tax which sometimes accompanies "S" status.

## **7. WILL IRS RESPECT THE RESTRUCTURING?**

### **7.1. NPC Is Charging Too Much.**

The IRS might argue that the NPC is charging too much for its services. However, there are many examples in the marketplace showing how high a percentage of gross revenue companies charge for the basket of services described in ¶4, e.g., Kaiser Permanente's contract with the Southern California Kaiser Medical Group.

Of course, this problem is fact specific. Assume the PC netted \$300,000 for its owner (between compensation and dividends) on a \$600,000 gross, and now the NPC is established to shift \$100,000 to the 4 children age 14 or old. That means the NPC is charging about 17% of gross revenues. That should be justifiable to the IRS if, for example, Kaiser is charging its medical group 75% of gross billings for the same services.

By contrast, assume both H and W have their own PCs, each grossing \$600,000 and each netting \$300,000. The NPC only has to charge about 8% of gross. Again, at such a low percentage it is hard to believe the IRS will be able to seriously object.

### **7.2. NPC's Employee Is Paid Too Little.**

Assume:

- (i) the NPC charges the PC \$100,000 for services,
- (ii) the NPC's only employee is W who is paid \$20,000 for her services, and
- (iii) the other \$80,000 goes to the children as "S" corporation shareholders.

IRS might argue W is underpaid and reallocate income from kids back to W.

### **7.3. Documentation.**

W must have a written employment agreement.

### **7.4. Evidence Of The Market.**

Another element of defense is evidence of the compensation level of comparable positions in firms like Kaiser.

### **7.5. Tax Structuring.**

If (i) the NPC is an "S" corporation and (ii) its employee is a family member, then the IRS can increase the employee's compensation, thus reducing the dividend to the shareholders.<sup>7</sup> This can be avoided by using non-family member as the NPC's employee.

## **8. ADVANTAGE IN RECRUITING PROFESSIONALS.**

### **8.1. New Professional's Expectation To Be An Equal.**

Most professionals associating with a practice expect to become "equals" or "partners." Yet the existing professional may have invested substantial sums in equipment and in building the practice (time, effort, money for public relations) for which the existing professional wants recognition (goodwill).

However, new professionals will not want (and may not be able to afford) to buy into the practice as an equal, partly due to the fact that the new professional will be responsible for some of the new income generated. A reorganization - better than a sale - reflects the relationship between the established professional and the new working professional. Separating ancillary income from the PC is one method of separating asset income from professional service income.

To summarize, the restructuring considers that:

- (i) a new professional would have difficulty affording the buy-in; and/or
- (ii) the existing professional may not want to sell.

The contract between the NPC and the PC helps shift significant value from the PC to the NPC. That makes it:

- (i) easier for a new professional to afford the PC buy-in, if any is required; and
- (ii) more palatable for the existing professional to sell a piece of the PC, since the biggest value resides in the NPC which will not be shared with the new professional.

### **8.2. Special Factors For Physicians.**

- (i) expands use of ancillary facilities;
- (ii) maximizes benefit of management experience;
- (iii) expands available expertise of practice, including experience with

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<sup>7</sup> IRC §1366(e).

new procedures; and

- (iv) provides for shift of "on call" responsibility.

## 9. **ASSET PROTECTION.**

Many claims against a professional are in the nature of malpractice. The NPC:

- (i) is no longer your asset; and
- (ii) is not practicing the profession.

Therefore, it should be free from malpractice claims.

Alternatively, the 2nd corp. might also be a PC which practices ancillary, lower risk services.

## 10. **CAN I GAIN THE BENEFIT OF ANOTHER PENSION?**

There are limits on multiple pensions plans for individuals. Congress passed laws that treat as one, for pension purposes, corporations and businesses that seem separate but have certain relationships.

However, the benefit is sometimes available by avoiding "aggregation."

### 10.1. **Impact Of Withdrawn Regulations.**

The IRS issued comprehensive regulations for some of the aggregation rules, e.g., the affiliated service group rules. However, the IRS withdrew the regulations in August, 1993. Without the guidance of regulations, auditing IRS agents may have little guidance or interest in this area.

### 10.2. **Avoid Controlled Group Rules.**

Assume you currently own 100% of the PC. You must own less than 50% of the NPC. (We recommend that you and your spouse own none of the stock.)

The other stock must be owned by people whose ownership is not attributed to you. e.g., it should not be owned by minor children.

One possibility is to transfer the stock to a hospital through a charitable remainder

trust.

**10.3. Avoid §414(m)(2) Affiliated Service Group Rules.**

The NPC's owner should not be an employee of the PC.

**10.4. Avoid §414(m)(5) Management Service Group Rules.**

This aggregation rule can be avoided if the NPC's management and other services to the PC are 50% or less of its business activities. This might be done by (i) having the NPC manage two (2) or more PCs or (ii) using a NPC that also has other significant business activities.

Another way to avoid the Management Service Group Rules is for less than 50% of the compensation provided by the NPC, for services performed for the PC, to be provided to individuals who perform a significant amount of management functions for the PC. This might be done by having most of the compensation paid for other activities, e.g., providing furniture, fixtures, equipment and facilities. This can be easily accomplished at the initial contract stage.

**10.5. Take Compensation From NPC.**

One possibility is for the professional to also be an NPC employee. Then the NPC will establish its own pension plan. The professional is now covered by the PC's and NPC's pensions.

Another possibility is for the professional's spouse to be an employee of the NPC, provide services and be covered by its pension.

**10.6. Use Different Pension Consultants.**

The firm that handles the PC's pension should not handle the NPC's pension. Otherwise, you are putting the pension consulting firm in an uncomfortable position.

**10.7. What If I Cannot Meet These Requirements?**

Assume you cannot meet these difficult requirements to gain the benefit of a second pension.

In that case the benefits of restructuring are limited to:

- (i) assistance in attracting new professionals; and
- (ii) placing some of what would otherwise be your assets in a somewhat more protected position.

### **10.8. Are There Alternatives To Pension Plans?**

A multi-employer welfare benefit trust permits you to contribute money to a tax-sheltered vehicle on a tax-deductible basis. It involves the tax-deductible purchase of whole life insurance. The cost of covering employees is usually low, and contributions on your behalf do not affect and are not affected by your pension contributions. However, this is not designed to build retirement funds; it is designed to provide a death benefit.

### **10.9. Are Pensions Protected From Creditors?**

The U.S. Supreme Court ruled in June, 1992, that ERISA plans are exempt from creditors. By contrast, IRAs are only protected to the extent you can prove you actually need the funds for retirement.

ERISA plans include most money purchase pension plans, defined benefit pension plans, target benefit pension plans, profit sharing plans, ESOPs, 401(k)s and Keoghs.

However, you may also wish to take certain precautions until we have some experience under this new rule:

#### **10.9.1. Don't Be Your Own Trustee.**

Neither you nor your spouse should be the trustee. Instead, hire a bank (which has a trust department) or other corporate trustee.

#### **10.9.2. Don't Be The PC's Only Employee.**

Do not transfer all the employees to the NPC. Leave at least a couple behind with the PC.

There are liability reasons to leave personnel performing paraprofessional services in the PC (to avoid their malpractice harming the NPC).

#### **10.9.3. Don't Be The PC's Sole Shareholder.**

This is often the most difficult step to take. In many situations it is impossible.

In situations where there is more than one professional, each should be a shareholder of this low value PC. Redeeming their shares upon departure at fair market value can be accomplished inexpensively and can be grounds for enforcing a covenant not to compete. See Business & Professions Code §16600-16602.

## 11. **COSTS.**

### 11.1. **Initial.**

The initial cost includes:

- (i) lawyer and CPA consulting time, including a tax analysis of transferring the assets from the PC to the NPC (\$750 - \$1,500);
- (ii) establishing the NPC (\$2,400);
- (iii) preparing an irrevocable children's trust (if you are not attempting to gain the benefit of a second pension) (\$1,500 - \$2,000); and
- (iv) preparing necessary contracts
  - (a) NPC providing services to PC (\$1,000);
  - (b) buy-sell agreement in PC (if more than one professional owns stock) (\$1,500);
  - (c) employment agreement for key professional with the NPC to justify the payment of high compensation (\$750); and
  - (d) minutes of the board of directors of the corporations (\$250 each).

A range of costs is quoted in three of the four items because the actual cost partly depends upon how many meetings and phone calls are required with you and your other advisors (CPA; pension consultant).

A fixed fee is quoted for establishing the NPC since that includes two (2) items that make up the cost of a new corporation:

- (i) legal fees; and

- (ii) fees paid to the Secretary of State and the company that manufactures corporate minute & stock books.

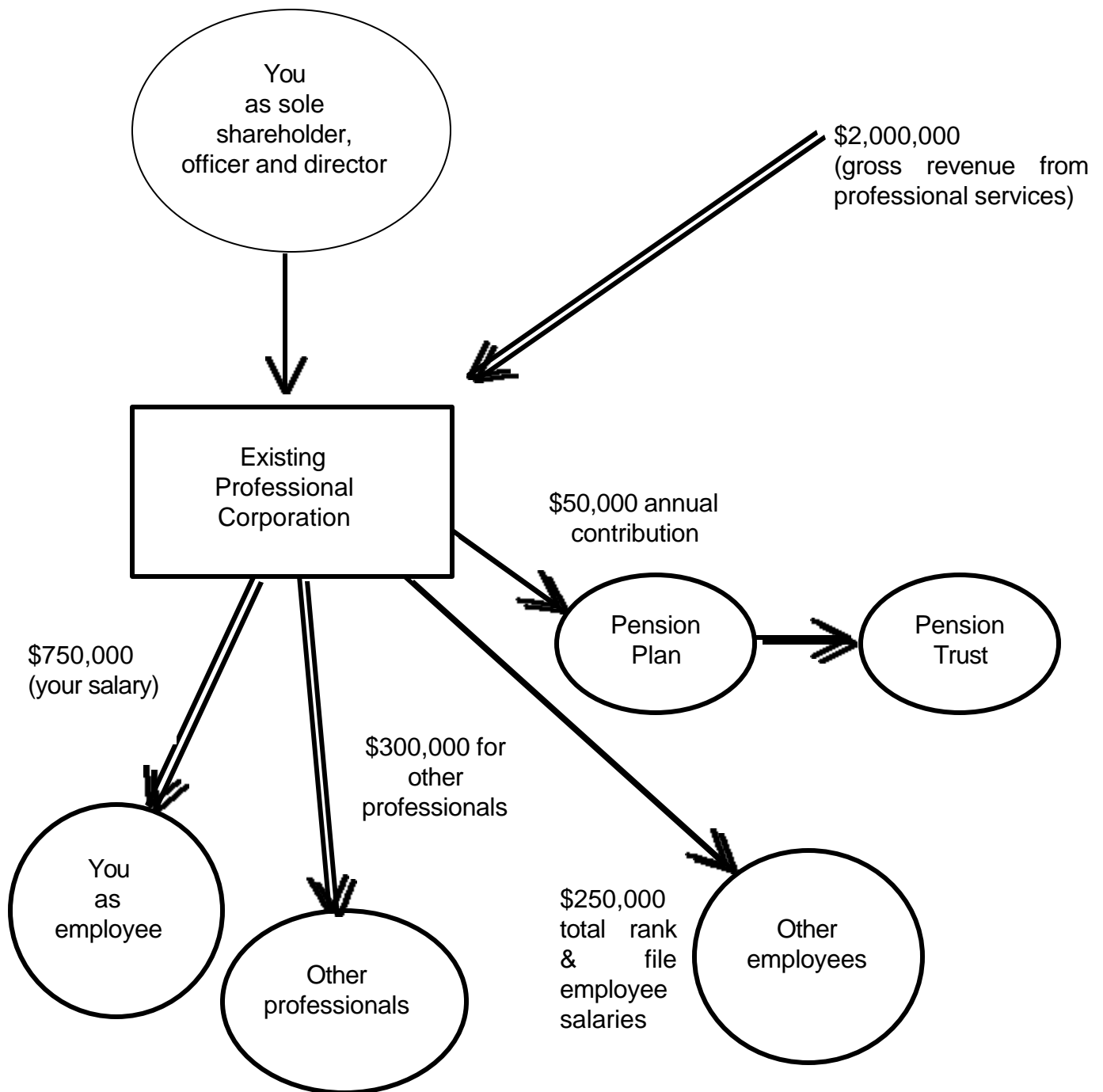
#### **11.2. Annual.**

The only added annual legal cost is preparation of the NPC's annual minutes.

The NPC will need accounting services and a tax return. If you take a salary from the NPC, you will contribute a 2nd time to Social Security. If you qualify for a 2nd pension, additional costs include 5500s for the new plan.

## RESTRUCTURING A PROFESSIONAL PRACTICE

Diagram #1



## RESTRUCTURING A PROFESSIONAL PRACTICE

Diagram #2

