How to Handle Ancillary Businesses: ASC, Optical, and Real Estate

Daniel M. Bernick, Esquire, MBA*
The Health Care Group®
Plymouth Meeting, PA

www.healthcaregroup.com

* Financial Interest

Financial Interest Disclosure

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- Shareholders of and Consultants with The Health Care Group, Inc. and Health Care Consulting, Inc.
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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

If You Have Separate Entities...

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

Buy-Outs

- 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

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
- Why they are called “professional” entities

Non-Professional Entities

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

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

Choice of Entity Drivers

- Taxation of yearly operating income
  - E.g. state corporate taxes
- Tax withholding
  - Shareholders in a corporation get W-2s
  - Members of an LLC get K-1s
- Advisor preference
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 credentialled 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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