

Chapter 6

PLANNING ASSOCIATE BUY-INS AND OWNER BUY-OUTS

Co-ownership is the most complex form of practice succession due to the many areas which must be continually agreed upon by the owners. In co-ownership, another doctor(s) is admitted to the practice as an owner prior to your retirement. The five areas which owners must agree upon are: (i) allocation of compensation, bonuses, fringe benefits and retirement plan contributions; (ii) decision making and voting control; (iii) dispute resolution; (iv) admitting new owner(s); and (v) the buy-out of departing owner(s). Because of these complexities, it is difficult to keep groups together. Where groups do stay together, the owners hold regularly scheduled meetings to discuss practice business. Communication is the key factor in keeping groups intact for long periods of time.

Allocation of Compensation

Compensation, bonuses, fringe benefits and retirement plan contributions are usually allocated in one of five ways or through a combination as follows: (i) by the productivity of one owner as a percentage of the productivity of all owners; (ii) by ownership percentage; (iii) equally; (iv) by management and administrative responsibilities; and/or (v) by the number of days, half-days or time spent working in the practice. Note that retirement plan contributions are based on total compensation by law and it is difficult for multiple owners to agree on the same plan design and funding level.

The owner-employee employment agreements allocate owner compensation and bonuses. Such agreements usually contain the similar provisions provided for in an associate employment agreement with the following exceptions: (i) the compensation is more generous for owners than associates; (ii) the restrictive covenants are generally for a longer period of time for owners than for associates; (iii) fringe benefits, expense and time-off policies are generally more liberal for owners than associates; and (iv) it is usually more difficult to terminate the employment of an owner versus an associate.

Decision Making Control

Decision making control can usually be equally allocated among the owners or vested in one owner under the particular state's close corporation or shareholder agreement statutes. Please note that not every state has such a statute in effect. For those states which do, the "founder" or owner can avoid the retention of a 51% ownership interest in the practice or the use of a separate class of stock for voting and non-voting interests. If the practice operates in corporate format under such a statute, operational control or the "tie-breaking" vote can be vested in the founder or senior doctor so long as such doctor owns at least one share of the professional corporation's stock. Voting control can also be allocated to the other doctors in order of seniority or by some agreed upon method.

In a limited liability company, management control can usually be allocated through the operating agreement, depending upon the state.

The incoming doctor(s), however, would usually desire to share equally in decision making or operational control of the practice. If not, the incoming doctor(s) would desire to reduce the practice value to reflect a "lack of control" discount. These matters are subject to negotiation.

Dispute Resolution

Dispute resolution devices should always be in place in co-ownership arrangements and provide an important role in resolution of problems. Dispute resolution devices can also resolve voting control and decision making deadlock. The buy-sell agreement, close corporation or other shareholder agreement or operating agreement for a limited liability company would typically contain one or a number of dispute resolution devices which would affect an owner's buy-out or departure from the practice.

Associate Buy-In

The valuation of the practice and co-ownership is identical to the valuation in its complete sale, except that the incoming doctor acquires a proportionate interest in the practice. For example, if the incoming doctor produces 50% of the doctor revenues, the incoming doctor would acquire a 50% interest in the practice. Alternatively, if the incoming doctor produces 25% or 33-1/3% of the practice revenues, such incoming owner would acquire a 25% or 33-1/3% interest in the practice. In short, the interest acquired by the incoming doctor should match his or her percentage of practice productivity. This allows the new doctor to both pay the practice interest and not reduce compensation below the associate level.

Where two or more professionals desire to be co-owners, the mechanism to accomplish such a result is for the new doctor to acquire some percentage of the professional corporation's stock or an interest in the practice which operates as a limited liability company. If the practice operates as a sole proprietorship prior to co-ownership, the incoming doctor may acquire a proportionate interest in the assets of the practice and both or all owners would contribute such assets to a newly formed limited liability company, S or C corporation. For those practices not already operating as professional corporations, the limited liability company format provides greater flexibility for admitting owners and paying out departing owners than do professional corporations. The reason for this is that limited liability companies are taxed as partnerships, yet provide limited liability for the acts of other owners and employees in the same manner as do professional corporations. If the practice already operates as a professional corporation, there are usually negative tax effects associated with liquidation and then forming a limited liability company. However, this problem may be minimized in the future, pending the direction of personal goodwill attributable to the shareholder(s) of a professional corporation.

Where the incoming doctor acquires stock in the professional corporation, particularly where the goodwill is included in the value, it can be burdensome for such doctor to make the payments, as such payments are made in after-tax dollars. A possible solution may be as follows. Balance the tax benefit to the seller who receives favorable capital gains treatment, with the tax detriment to the purchaser who pays for the stock in after-tax dollars. Then adjust the purchase price of the stock to reflect the tax benefit to the seller and the tax detriment to the purchaser.

The verification analysis of the purchase price completed by the accountant for the purchaser should indicate what the incoming owner can afford to pay, within a measured time period, without reducing compensation from the associate level.

In some situations, a mechanism has been used to admit incoming owners to professional corporations by valuing the stock at its "lowest reasonable value". The incoming doctor(s) may receive disproportionately less compensation than does the senior doctor(s) during the first few years of ownership. The effective result is that a new doctor's interest is increased by compensation adjustments for the value of the personal services rendered to the professional corporation, over time.^{1, 2} For example, the new doctor(s) may be required to meet certain performance or productivity standards prior to sharing equally with other doctors in the compensation pool. Over five consecutive years, the senior doctor(s) and new doctor(s) could allocate available compensation on the basis of: (i) 70%/30%; (ii) 65%/35%; (iii) 60%/40%; (iv) 55%/45%; and (v) 50%/50% in year five and thereafter. As an alternative, there may be a "guaranteed" bonus to the senior doctor(s) who is arguably worth more to the professional corporation than is the new doctor(s). Assuming that the senior doctor(s) actually provides management and administrative services to the professional corporation, such doctor(s) could be paid for those services under a management services agreement(s) with the practice. This method of associate buy-in is complex. Additionally, it is possible that the disproportionate compensation adjustments could be considered as payment for stock. If so, the payment for stock could be recharacterized to be made in after-tax dollars by the incoming doctor(s). There is also a risk to the existing doctor(s) of not receiving the disproportionate compensation, as it should not be guaranteed by the incoming doctor(s).³

Alternatively, by valuing the stock at its fair market value inclusive of goodwill, the purchase price can be guaranteed under a promissory note and secured by a "pledge" of the incoming owner's stock under a pledge and security agreement. This assumes that there is some significant component of seller assisted financing as is typical in co-ownership arrangements.

In the event of a dispute among doctors, an additional consideration is that the doctor who acquires a stock interest for its "lowest reasonable value", coupled with the use of compensation adjustments, may argue that his or her interest is actually worth a higher fair market value.⁴ The argument would be that the value of the professional corporation should now include goodwill. In the event that the new doctor would leave the corporation's employ by way of a dispute, such doctor could receive more upon departure than he or she initially paid for the stock, irrespective of any buy-sell agreement which states otherwise.

¹ Muskogee Radiological Group, Inc. v. Commissioner, T.C. Memo, 1987-490.

² Tax Planning for Corporations and Shareholders, Second Edition, Zolman Cavitch, Lexis Publishing, Matthew Bender & Company, Inc. 13.04[1], [2], [3].

³ Technical Advice Memorandum 944003.

⁴ Contemporary Obstetrics & Gynecology, Inc. (1966), 113 Oh App. 3d 75.

Although the seller receives less for stock appraised at fair market value inclusive of goodwill, because the purchaser pays the purchase price in after-tax dollars, the seller does receive capital gains treatment and security for payment of the purchase price. Additionally, by structuring the transaction in this manner, neither the seller nor purchaser need to be concerned with any recharacterization in the event of an audit. Finally, if a new doctor leaves the practice, the departing doctor cannot argue that his or her interest did not include goodwill.

Buy-Out of Departing Owner(s)

The buy-out of a departing owner(s) probably presents the single biggest challenge in co-ownership for continuance of future practice operations.

Buy-Sell Agreements

The buy-sell agreement may provide for the mandatory or optional purchase of an owner's interest in the practice entity and/or the other owner(s) if a specified triggering event occurs. The decision between a mandatory or optional purchase and sale is decided by the type of triggering event. An involuntary triggering event such as death or permanent disability or attaining a predetermined retirement age when the owner then elects to retire, normally would require a mandatory buy-out. Any other termination of employment with the practice, voting deadlock or dispute would provide for a buy-out at the option of the practice entity or the non-departing practice owner(s). Attached is a matrix as Figure 6-1 which describes those variables generally included in buy-sell agreements relative to triggering events, mandatory or optional buy-outs, payment terms and use of insurance for death or permanent disability.

The method of determining the price of a departing owner's interest may be the most difficult determination for the owners to agree upon, particularly where the shortage of doctors is reducing practice values. The purchase price would either be based upon a formula which will reflect future growth of the practice, depending upon the anticipated retirement date of existing practice owner(s), or will provide for a specified purchase price if the buy-out of the senior doctor is negotiated by the incoming doctor at the time of the buy-in. Both fixed values and formulas should be reviewed by the owners each year as an agenda item at the annual meeting with advisors.

Each triggering event may utilize a different purchase price for the departing owner's interest in the practice. For example, it may be appropriate to adjust the purchase price downward where the practice owner voluntarily departs or quits. The list, below, describes various methods for determining the purchase price under a buy-sell agreement.

- (a) Book Value. Although this method is simple, it measures only tangible assets which were paid for, then only at their cost and not their fair market value. Additionally, book value does not value intangible assets, e.g., goodwill or going concern value. Where book value is used, it is sometimes used in conjunction with a deferred compensation arrangement.
- (b) Agreed Value. A specific price or formula determined by agreement of all practice owners may be used. A buy-sell agreement using the agreed value method

requires periodic updating. Further, self-executing mechanisms for adjusting the purchase price or formula when practice owners do not update the agreed value or cannot agree on an updated agreed value should be drafted into the buy-sell agreement. A common self-executing mechanism is one that adjusts the most recent agreed value by increasing or decreasing it by the percentage change in annual practice revenues since the last agreed value. A virtue of agreed value is its certainty.

- (c) Appraised Value. An appraisal of the practice owner's interest as of a specific date may be used. The purchaser and seller may each pick one appraiser and average the values or agree on a single appraiser. If the purchaser and seller each pick an appraiser, the buy-sell agreement sometimes has the two appraisers pick a third appraiser, whose appraisal is binding. While paying appraisers may be an expensive way of determining the value, it may result in the most accurate determination of true practice value. One problem with appraisals is that they take time to complete.
- (d) Earnings Capitalization. This method determines value by multiplying earnings by an agreed multiple. Specifically, first determine average earnings, less appropriate owner compensation, averaged for the prior three to five fiscal years of the practice. The average earnings are then capitalized at a rate or return which would be required by a knowledgeable investor familiar with the risks of the particular practice. The reciprocal of the capitalization rate is the price/earnings ratio, "P/E". For example, a capitalization rate of 20% equals a P/E of five times, and a capitalization rate of 25% equals a P/E ratio of four times. If the capitalization of earnings approach is used, the buy-sell agreement should define: (i) the capitalization rate; (ii) weighted average earnings; and (iii) any adjustments to be made to earnings.
- (e) Combinations. Because each of the foregoing valuation methods have their own benefits and detriments, a combination of the above-described approaches may be advisable.

Because a cash transaction for the purchase of the practice interest may be unrealistic, the payment terms would provide for the payment of the purchase price in installments over a period of time. The length of installment would be determined, in part, on the purchaser's ability to finance the purchase.

The use of the funding mechanism of life insurance or disability buy-out insurance influences payment terms where death and disability are triggering events. Typically, all insurance proceeds constitute the down payment and the remaining purchase price is paid in installments, over some affordable term.

It is not unusual for the triggering event to influence the length of installment payments. For example, a practice owner who voluntarily leaves employment may be paid off, if at all, more slowly than one who dies or becomes permanently disabled.

In addition, installment payments require that interest be paid at certain minimal rates to avoid imputed interest. For example, the buy-sell agreement could provide that the interest would be equal to two percentage points below the prime rate, but in no event shall the interest rate be less than the amount necessary to avoid the imputation of interest under the IRS.

If the purchase price is paid in installments, the seller must consider the type of security he or she desires for the installment payments. First, any promissory note should be cognovit, not subject to any defenses, if the particular state permits this. In addition, the remaining or new owner should personally guarantee the practice's installment payments for stock. Also, installment payments may be secured by a pledge of the ownership interest purchased. Further, it must be determined whether the terms should restrict the practice's ability to borrow money, make distributions to owners, participate in mergers, sell substantially all assets, etc. In other words, it may be reasonable for the buy-sell payment terms to include, in effect, loan covenants.

A typical device for funding buy-out in the event of death is life insurance. Any life insurance policy(s) should be periodically reviewed to ensure that it is appropriate in terms of amount for purposes of the buy-sell agreement.

In recent years, disability buy-out insurance has become more prevalent, available and less costly than in past years. In general, there is a one or two year waiting period of required disability before the disability buy-out insurance pays off. While disability buy-out insurance is more available and less costly than in the past, it is not usually available in amounts as large as life insurance policies. Nevertheless, it is a useful idea to help supply liquidity. Disability buy-out insurance may be payable in a lump sum or over a period of time, usually five years.

To ensure that the departing owner does not enter into direct competition following the buy-out, the buy-sell agreement should include non-competition provisions. In addition, the buy-sell agreement should include non-disclosure covenants, whereby the departing owner agrees not to disclose or use for any purpose any of the practice trade secrets or other confidential information, e.g., patient lists or referral sources.

Deferred Compensation Arrangements

Payments for stock in a professional corporation are non-deductible for federal tax purposes. However, in certain circumstances and assuming certain tax requirements are met, payments for deferred compensation are tax-deductible to a professional corporation where utilized in the buy-out of an owner/shareholder in conjunction with the remaining shareholder(s) or professional corporation's purchase or redemption of stock. Because a professional corporation is subject to the highest corporate tax rate, 35%, such payments would generate a 35% tax benefit to the corporation. However, the deferred compensation payments to a departing shareholder for services previously performed are ordinary income and are not taxed at the lower capital gains rates.

The triggering events under a deferred compensation arrangement would typically track the terms of the buy-sell agreement.

It should be noted that IRC Section 1060(e) may impose certain informational reporting requirements where deferred compensation and similar arrangements are utilized in connection with the sale of stock. However, it should be noted that the Treasury Regulations provide that a "Top Hat Exemption Form" be filed with the Department of Labor within 120 days after any deferred compensation agreement is signed. Although the Department of Labor has not typically audited deferred compensation plans, failure to file the Top Hat Exemption Form will result in penalties similar to the failure to file a Form 5500 for a tax-qualified retirement plan.

Employment of Family Members

While in certain situations, the employment of family member(s), e.g., an owner's spouse as office manager, in a co-ownership arrangement can work well, there exist those situations where it does not. Employment of family member(s) should always be discussed prior to entering into the co-ownership arrangement.

Practice Valuation

In the event that the stock of the professional corporation is valued at its lowest reasonable value, the appraisal for the practice should support its value. That is, if the professional corporation has the liability of a guaranteed bonus or management fee payable to senior doctor(s), the fair market value would be reduced by the "booked" liability. If the practice has little or no goodwill, which may then be attributed personally to the individual owner(s)/doctor(s), the appraisal should support this arguable position.

Buy-Out Obligation Problem

The associate becomes an owner and buys into the practice. In time, the new owner becomes very productive. When the senior doctor retires or otherwise departs from practice, the new owner probably has no desire to buy-out his partner, the senior shareholder. Assuming that the new owner does buy-out the senior doctor(s), the new owner must hire additional doctor(s) to "stand in his or her shoes", when he or she then stands in the "shoes of the senior doctor(s)". This is one significant reason why co-ownership arrangements can fail, as this is a tremendous burden for the new doctor.

Timing the Associate Buy-In

You hire an associate in your practice who meets your performance expectations. You wish to retain that associate and recognize that he or she may leave your employ if no opportunity for ownership is available. As a result, you sell the associate half of your practice.

The structure of this sale may be through a solo group arrangement, with each of you owning your respective practices, which is recommended. As an alternative, the structure may be through common ownership of the same practice, e.g., co-shareholders of a professional corporation or co-members of a limited liability company.

Five to ten years after the buy-in, you elect to retire in accordance with your prior plans. At such time, the associate has either the option or the obligation to buy you out, as defined in the buy-sell agreement between your practice, you and the associate.

You now have 50% of the practice to sell when you retire rather than 100%. In addition, the profit which you hopefully made on the associate changed in character to payment for the first 50% of the practice.

In light of this situation, when do you hire the associate and when should the associate become an owner?

The answer depends upon the level of owner and associate production, "pent-up" demand, the availability of candidates at your retirement and the degree of need for someone to continue your practice in the event of your permanent disability or death.

Owner and Associate Productivity

As long as your personal productivity does not decrease significantly with an additional owner, notwithstanding that you may take more time off, you are still selling a full practice rather than half of a practice upon retirement.

A key consideration in the decision to hire an associate is the ability to meet a continually increasing demand for patient services. This demand should allow the associate to earn an "appropriate" living, while maintaining the current level of compensation to the owner. The owner should also earn a profit from the associate's efforts. Assuming these criteria are satisfied, the decision to hire the associate is probably sound.

Pent-Up Demand

Because the practice owner(s) has limitations on personal productivity, sometimes patient demand is not serviced and therefore dissipates. By not hiring an associate, the practice owner has made the decision that growth will be curtailed. That's fine as long as this decision is not made unconsciously. This continual and ongoing decision making process should be part of strategic and long term planning for the practice.

Availability of Acquisition Candidates

There is not an overabundance of candidates at this time, particularly good ones. This is an especially sensitive area for specialty practices, which typically conduct a national search for candidates and often early in the specialty training. This means that unless you hire the new doctor when you can, the new doctor may not be available when needed.

Practice Continuance

Assuming that you remain healthy, there may exist little concern about permanent disability or death. However, should either triggering event take place, you would desire that anyone who practices with you in a common facility or as a co-owner of the same practice, have

the obligation, as opposed to the option, to buy you out in accordance with predetermined terms and conditions and possibly through an insurance component, e.g., term life and/or disability buy-out insurance.

The bottom line is, although the simplest situation is to work by yourself until you retire and then sell 100% of your practice, to the extent that your productivity does not drop when an associate becomes an owner, selling a portion of your practice, e.g., one-half, to the associate should not hurt you monetarily.

The Complexity of Co-Ownership

The degree of complexity in co-ownership arrangements is tremendous. Planning for practice succession through the option of a co-ownership arrangement is much more difficult to successfully operate on a long-term basis than are the options of a complete sale, the associateship coupled with a later complete sale or a solo group arrangement where the practices remain separately owned.