

Selling a Professional Practice

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November 18, 2021

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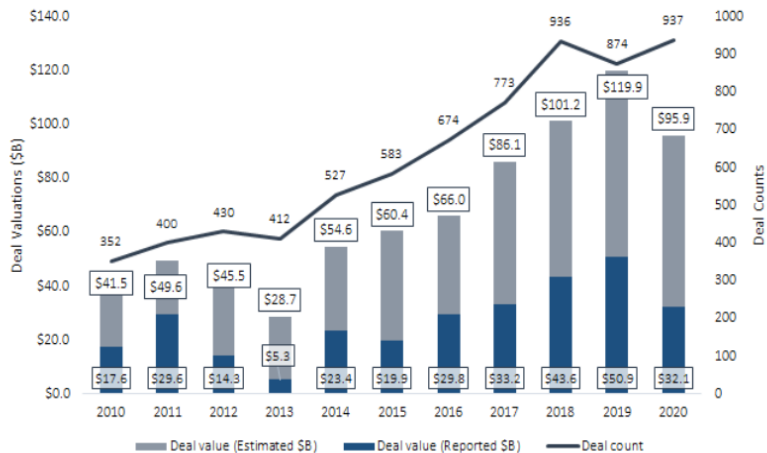
Outline

- **The Market for a Professional Practice**
- **General Sale Considerations**
- **Sales of Healthcare Practices to Corporate Acquirors**
- **Structuring Considerations in an Uncertain Environment**
- **Q&A**

The Market for a Professional Practice

Sale of Medical Practices and Corporate Ownership

Figure 1. Total PE Deals in Healthcare* – Reported Deal Value, Estimated Deal Value, and Reported Deal Count, 2010-2020



Petris Center/AAI analysis of PitchBook data.

SOURCE: PitchBook Data, Inc. Data has not been reviewed by PitchBook analysts.

NOTE: Data as of 3/30/2021. Valuations are reported in current dollars. Analysis conducted by PitchBook Data, Inc. and provided courtesy of Eileen Appelbaum and Rosemary Batt. The PitchBook database is dynamic and deal counts produced by the same search may vary as underlying data change over time. Deals defined according to Pitchbook's "standard PE methodology," including LBOs, add-ons, growth investments and secondary buyouts. Estimated total deal value in current dollars, 2010-2020 = \$749.5 billion, estimated total deal value in Jan. 2020 CPI-adjusted dollars, 2010-2020 = \$805.9 billion

- Sales to other professionals as well as third party investors.
- Healthcare was the 2nd largest sector for PE investment in 2020.
- There were 937 PE deals in 2020, with 364 in clinics and outpatient sector.

<https://publichealth.berkeley.edu/wp-content/uploads/2021/05/Private-Equity-I-Healthcare-Report-FINAL.pdf>

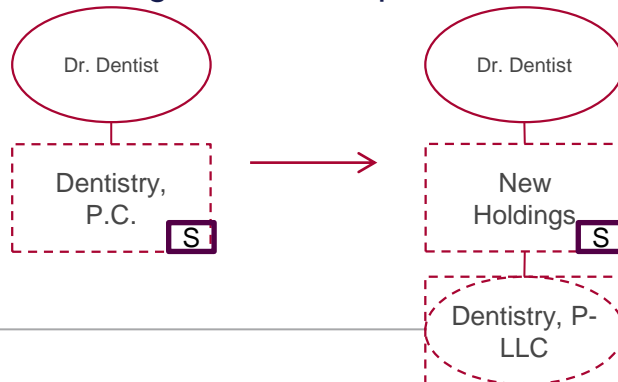
Sale of Legal Practices

- Generally only sales to other professionals.
- ABA Model Rule of Professional Conduct 5.4
 - “A lawyer or law firm shall not share legal fees with a nonlawyer” with a few exceptions.
 - “A lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law.”
- BUT the ABA passed Resolution 115 in February 2020.
 - Encourages jurisdictions to consider regulatory innovations to improve accessibility, affordability and quality of legal services.
- Several states have broadened their rules, but generally do not allow significant equity ownership in law firms by passive investors.

General Sale Considerations

Asset versus Stock Sale

- Asset sales generally preferred since they provide a basis step-up, reducing future income through depreciation/amortization.
- Easier to structure a asset basis step-up with a flow-through entity.
 - Since the income of professional practices generally is distributed each year, they are typically formed as flow-through entities.
- Thus, even if structured as a sale of equity, basis step-up is often available through a 754 election.
- Pre-Closing Restructuring for an S Corp, Rev. Rul. 2008-18



Asset Allocation

- Residual allocation method.
 - Class I – Cash and cash equivalents
 - Class II – Actively traded personal property
 - Class III – Accounts receivable
 - Class IV – Inventory
 - Class V – PP&E
 - Classes VI and VII – Intangible property, including goodwill
- Seller will want to limit allocations that generate ordinary income – accounts receivable, inventory, depreciation recapture, and a non-compete.
- Allocations to Covenants Not to Compete
 - Form 8594 specifically asks about this.
 - Impact on enforceability?

Earnouts and Installment Sales

- Earnouts can be beneficial to bridge differences in valuation.
- Installment sales often used to ameliorate the amount of cash needed up front.
- From a tax perspective, both generally can be reported on the installment method.

Sales to Corporate Acquirors

Corporate Practice of Medicine (CPOM) Intro

- State-level doctrines that generally:
 - Prohibit business entities and unlicensed individuals from providing healthcare services, employing licensed healthcare professionals (“HCPs”) to provide healthcare services, or otherwise exerting control of the provision of healthcare services by HCPs.
 - Require that HCPs have control over diagnosis and treatment of patients and, sometimes, the setting of fees for services.
- Rationale
 - Inherent conflict between patient care and corporate profits.

CPOM: A Misnomer

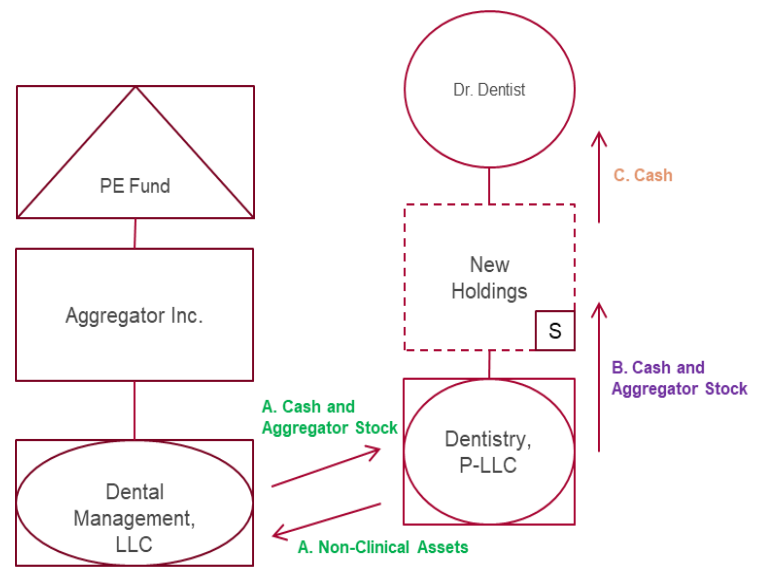
- **C**orporate
 - Does not apply only to corporations
 - Also restricts LLCs, partnerships and other business entities
- **P**ractice
 - Does not apply only to the treatment of patients
 - Also restricts, among other things, marketing, hiring and oversight of HCPs, compensation, fee splitting, budgeting and billing practices
- **O**f
- **M**edicine
 - Does not apply only to services typically provided by physicians
 - Also restricts activities typically undertaken by dentists, physical therapists, veterinarians, and sometimes social workers

CPOM: Prohibitions

- Does not allow ownership by unlicensed persons of entities that provide healthcare services
- Fee-splitting between HCPs and unlicensed persons (e.g., service providers)
 - Management Services Agreements (MSA) with Management Service Organizations (MSO) highly scrutinized
 - Compensation must reflect FMV
 - Sharing based on a percentage of revenues or profits generally prohibited
 - HCPs must retain control of clinical operations

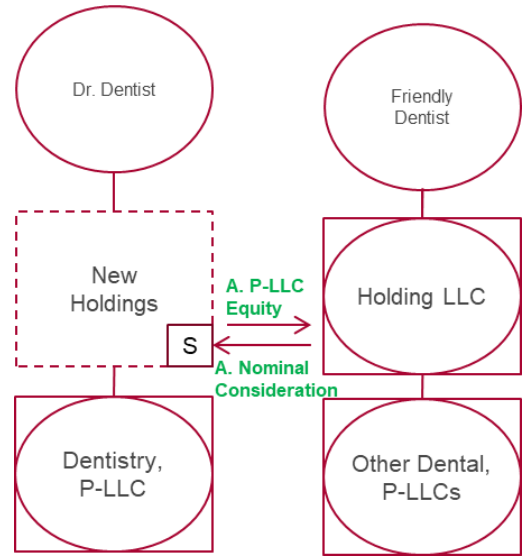
Typical Corporate Acquisition Structure

1. Sale of Non-Clinical Assets



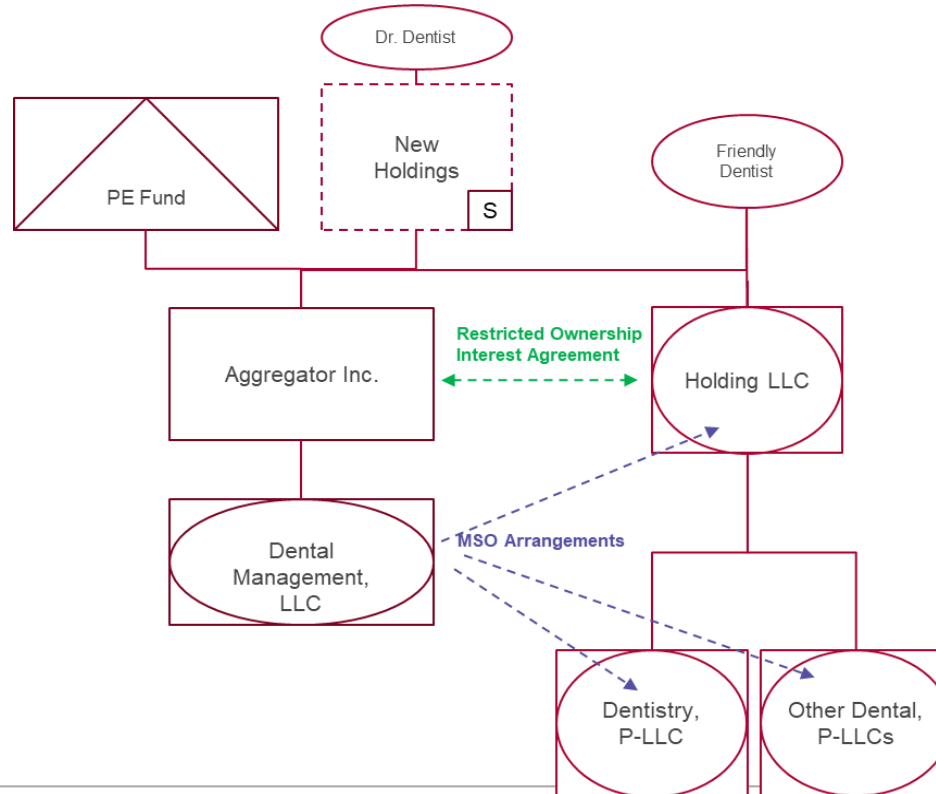
Typical Corporate Acquisition Structure

2. Transfer of Professional Entity to PE-Friendly Employee



Typical Corporate Acquisition Structure

3. Enter into Management Services Arrangement

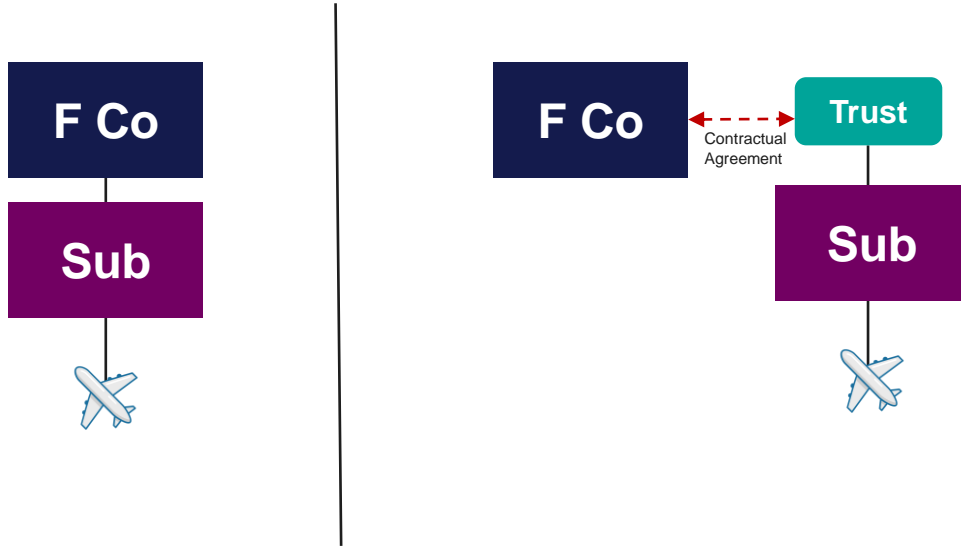


Consolidation for Tax Purposes

- Section 1504(a)'s direct ownership requirement satisfied with beneficial ownership of stock, not legal ownership.
- Several IRS rulings support consolidation with legal ownership.

Rev. Rul. 84-79

- Legal title alone does not constitute direct ownership.
- Possession of “everything but legal title” equates to direct ownership.



PLR 9605015

- Typical MSO arrangement.
- HCP entered into a pledge agreement severely restricting his rights.
- HCP was required to vote in accordance with the Acquiror and was told who to appoint as the Board and officers. HCP was not entitled to any dividends or capital appreciation.
- IRS ruled that HCP's ownership constituted beneficial ownership.
- PLR 9752025 revoked this ruling.

FSA 199926014

- Concludes that if beneficial ownership is precluded by state law, then that governs.
- Thus, there cannot be consolidation if state law precludes not only legal, but also beneficial, ownership by anyone other than a HCP.

- Typical MSA structure upheld and consolidation allowed.
- Each HCP entered into a MSA and the MSO performed all administrative and support services for a fee.
- The HCP was the director of the professional entity, but the MSO had the right to terminate the director agreement for any reason, without penalty.
- HCP only paid a nominal amount to acquire legal title of the shares, and ownership was subject to transfer restrictions.
- There was a representation that applicable state law did not prohibit the beneficial ownership of stock in each PC by the MSO.

Takeaways

- **Consider state law and risk tolerance.**
- **Review MSAs and other contractual restrictions on control and economics.**

Structuring Considerations in an Uncertain Environment

Considerations in Light of Legislative Proposals

- Elect out of installment method if sale closed before effective date of rate increases.
- Structure around the 3% surcharge on income over \$5MM.

Questions & Answers

Morgan represents clients in domestic and cross border M&A, fund formation and structuring, reorganizations and partnership agreements.

Morgan is an adjunct professor of international tax at Temple University Law School, chair of the CLE Committee for the Partnership Committee of the ABA Tax Section, and on the board of both the Philadelphia Bar Association Tax Section and the Philadelphia Tax Conference. She is a frequent speaker on a variety of transactional tax matters.



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Troutman Pepper Overview

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combined
attorneys

23
U.S. cities

Top 10%
of all law firms for
innovative approach
and anticipating
client needs.

– BTI Client Service A-Team 2018 list

47th
projected
Am Law
ranking

Thank You!

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