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Newsletter Article Reprint

Entity Selection (by William P. Prescott, M.B.A., J.D.)

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Are you forming or purchasing a practice? Are you planning to practice with another doctor? What entity form is appropriate and what do you need to know to select the right one?

There are basically five entities for practice operation. They are a sole proprietorship, C corporation, S corporation, limited liability company ("PLLC" or "LLC") or general partnership. This choice should be driven by two factors; liability protection and tax benefits.

Liability Protection

While a sole proprietorship is the simplest form of entity, it provides no liability protection in and of itself. So the decision to practice as a sole proprietorship versus a C or S corporation or a PLLC should be based upon two criteria. First, the greater number of employees that you have, the greater the need to consider an entity that provides liability protection and all entities with liability protection provide it at the same level, with minor exceptions. Second, if there is more that one doctor in the practice, it is essential to consider operating in an entity that provides liability protection. However, you are always liable for your own acts. An entity that provides liability protection protects you from the acts of other doctor(s) and often, but not always, for the acts of your employees against others or your employees' claim(s) against you.

How can operating as a sole proprietorship or any other entity assist to insulate you against liability? Simple, carry insurance that really insures and consider an umbrella policy. And most of all, adopt and fund a taxqualified retirement plan, e.g., a safe harbor 401(k) profit-sharing plan for younger doctors or a defined benefit plan for older doctors to contribute substantially more. Unlike simple plans and IRA's, the tax-qualified plans are absolutely creditor proof, except for child support orders and Federal tax liens. This assumes that the owner is not the only participant in the plan. As to solo groups, whereby two or more practices operate separately in the same facility, the need is less pressing to operate in an entity formed with liability protection, as compared to co-ownership. Nevertheless, such
practices often hold themselves out to patients and the public as "partners", which creates additional liability to one doctor for the acts of another doctor within the solo group.

Two or more doctors practicing together are a partnership by default, unless another entity is formed. And partners are jointly and severally liable for the acts of the other partners. Sometimes, partnerships consist of S or C corporations as partners in an effort to limit liability, particularly in California or Hawaii, whereby professional practices are not permitted to operate as PLLC's. In the other 48 states, sometimes the PLLC's members consist of C or S corporations, although I believe that such an arrangement creates unneeded complexity and requires additional tax returns to be filed. In addition, I believe that a C or S corporation provides better liability protection than does a partnership of PLLC's.

It is not enough just to form a C or S corporation. The entity must "look and act" as a corporation to ensure liability protection through the preparation of shareholder's and director's minutes that authorize significant corporate activity. These minutes are typically prepared on an annual basis and are contained in the corporation's record book.

While it has been said that PLLC's are not required to comply with the formalities that corporations follow, our Firm has lately been preparing minutes for PLLC's in the same manner as we do for corporations in an attempt to ensure liability protection.

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Tax Ramifications

Currently, all entities are almost the same relative to tax issues relating to practice operations, although C corporations do allow for certain "executive" health reimbursements not permitted in other entities, as well as some other benefits. Additionally, S corporations may provide for "reasonable" distributions that escape the 2.9% Medicare tax above the Social Security Wage Base.

The difficulty regarding the tax issues on entity selection is in the sale of the practice or practice interest. In a complete sale, it is best to be an entity other than a C corporation for ten years or more, absent the helpful recent cases allowing for the sale of personal goodwill at one tax level.

To acquire an interest in a C or S corporation, stock must be purchased and sold. The purchaser pays for stock in after – tax dollars and the seller receives favorable capital gains treatment. This tax differential can be "balanced" by adjusting the tax-neutral fair market value by the tax detriment to the incoming doctor versus the capital gains treatment to the seller. We have found this reduction to be roughly 22%.

As an alternative, parties often agree that the value of the stock would be its lowest "reasonable" value, e.g., the value of the tangible assets or "book value" that is even lower, with the personal goodwill payable through compensation adjustments. Here, the incoming doctor's compensation is reduced and the practice owner's compensation is increased through the payment of a "guaranteed bonus" or management fees in exchange for the actual management services rendered. Upon the departure of a shareholder, the stock would still be valued at its lowest reasonable value, as determined by a formula contained in a buy-sell or share redemption agreement. Additionally, the departing owner would receive payments of deferred compensation or continued compensation equal to the value of the personal goodwill or, in fact, the payment of personal goodwill since the Martin Ice Cream and Norwalk vs. Commissioner cases in 1998.

However, if the entity is a C corporation, the Pediatric Surgical Associates vs. Commissioner case decided April 2, 2001, creates both with reasonable compensation concerns and difficulty in the payment of compensation adjustments.

Many advisors favor the use of a PLLC for admitting new members and cashing out departing members because when a new doctor is admitted and the PLLC is taxed as a partnership, an Internal Revenue Code Section 754 election is made. This election treats the purchase of the interest similar to a favorable asset sale.

The bottom line is that the greater number of employees you have, the more important it is to consider an entity that provides liability protection.Where two or more doctors practice together, it becomes very important to consider practicing in an entity that provides liability protection.

While advisors can now work around the unfavorable tax consequences of practicing in a C corporation upon admitting a new doctor, cashing out a senior doctor or selling the C corporation's assets, the most difficult entity to work with remains the C corporation.

Fortunately, retirement plans are entity neutral, unlike in the past when the C corporation was clearly the most favored entity. As to the practice real estate, consider the use of an LLC or a family limited partnership that is taxed favorably as a partnership, as compared with other entities. The LLC or family limited partnership also provides for a limited liability in varying degrees, as the general partners in a family limited partnership are jointly and severally liable for the acts of the other partners.

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