It is critical for buyers and sellers alike to understand the tax implications of different practice acquisition structures. One of the earliest decisions to be settled upon between the parties is whether to structure a sale of a physician practice as a sale of assets, equity or some other form. This issue can be complicated since buyers and sellers may benefit from opposing structures from a tax-perspective, and since the form of transaction is often dependent upon the transferability of seller obligations and the corporate practice of medicine (CPM) laws and fee-splitting laws of a particular state.

The CPM doctrine generally prohibits a business corporation from practicing medicine or employing a physician to provide professional medical services. The CPM doctrine prohibition manifests itself in a variety of state laws, regulations and court opinions addressing ownership or control of healthcare providers by individuals or corporations that cannot directly provide healthcare services. Some states have carved out certain corporate employers as exceptions to the CPM doctrine prohibition, such as hospitals, health maintenance organizations and professional corporations; other states merely prohibit the practice of medicine without a license or the sharing of fees between licensed and unlicensed individuals; and a third category of states flatly prohibit the ownership of medical practices or employment of professionals by nonprofessionals. In order to highlight differences in the tax implications of an asset versus a stock sale in the context of a physician practice sale we have set aside the CPM doctrine and state regulatory-related issues, although parties are encouraged to address these issues as threshold matters.

In an asset sale, a buyer purchases certain assets and liabilities of a physician practice, but is able to leave behind other assets and liabilities that a buyer does not wish to assume. In a stock sale, a buyer purchases a seller owner’s equity in a physician practice and essentially “steps into the shoes” of the seller and takes the practice with its assets and liabilities (unless otherwise carved out through the purchase agreement). The operation of a seller’s practice continues in an uninterrupted manner. Most, if not all, of the accounts on the physician practice’s balance sheet continue with the practice for the benefit of the buyer in a stock sale.

Differences in the income tax treatment of C-corporations and S-corporations should be considered at the onset of structuring a transaction. A C-corporation is subject to double taxation of income since a C-corporation pays tax on its earnings, and its shareholders are taxed again when corporate earnings are distributed to the shareholders in the form of dividends. S-corporations, on the other hand, are generally subject to just one level of taxation. In other words, the income is taxed only to the corporation’s shareholders. The increased tax burden on C-corporations and their shareholders is often taken into consideration by physician practices when evaluating a proposed buyer’s purchase price since the net purchase price after taxes for C-corporation shareholders can be substantially less than that for S-corporation shareholders.

**Asset Sales**

From an accounting perspective, a buyer records the assets and liabilities at the fair market (acquired) value assigned to them as part of the sale transaction. This may increase or decrease the carrying value and/or amount of annual depreciation with respect to individual assets and liabilities. From a tax perspective, a selling physician practice recognizes a taxable gain or loss based on the difference between the allocated sale price and the tax basis of the assets and liabilities. If the selling physician practice is a C-corporation, an asset sale typically results in an increased tax burden.

Currently, federal long-term capital gains rates for most sellers are between 15 and 23.8 percent (depending upon a seller’s marginal income tax bracket). Federal ordinary income tax rates, however, can be as high as 39.6 percent (or even higher since a new Unearned Income Medicare Contribution Tax of 3.8 percent has been applied to net investment income for taxpayers whose modified adjusted gross income exceeds $200,000 (for single filers) and $250,000 (for married filing jointly)). Furthermore, if a selling physician practice is an S-corporation that was formerly a C-corporation within the 10-year built-in gain (BIG) tax recognition period, then the assets could trigger corporate-level BIG under IRS Section 1374.

On the other hand, asset sales typically benefit buyers from a tax perspective. When a buyer purchases a physician practice’s assets, the buyer acquires a “stepped-up” basis for capital assets, based on the portion of the purchase price allocated to each asset. By setting higher values for assets that depreciate quickly, such as equipment, and lower values for assets that depreciate slowly or not at all, such as goodwill, a buyer can reap tax benefits from the purchase price, as depreciable assets can be written off in future fiscal years. Asset sales also allow buyers to avoid inheriting potential liabilities. This is particularly important to a buyer if a physician practice has a significant number of actual or potential liabilities, such as malpractice lawsuits or third-party payor claims liability, and it is difficult to quantify the amount of those liabilities.

**Stock Sales**

In a stock transaction, a business’s assets and liabilities remain in the entity and continue to be carried and/or depreciated in the same manner as before the transaction. Sellers generally prefer a stock sale because it allows them to completely step away from the practice and avoid responsibility for any future liabilities relating to the practice, although purchase agreements are often structured to shift liability responsibilities back to the seller for the operation of the business during the period prior to closing through indemnification provisions. Additionally, in stock sales, a selling physician practice recognizes a gain or loss based on the difference between the price paid and his or her current basis in the stock. The gain
or loss realized is typically treated as a capital gain and thus subject to lower federal capital gains rates. Long-term capital gain rates are presently between 15 and 23.8 percent for most sellers (depending upon a seller’s marginal income tax bracket).

In a stock sale, the basis of the assets at the time of the sale sets the depreciation basis for the buyer. Thus, generally buyers lose the ability to maintain depreciation on assets. Stock sales can also create heightened risk for buyers, since a buyer may assume liabilities of a selling physician practice that only become known after the sale.

Finally, when a buyer is a tax-exempt entity, provisions of the Internal Revenue Code governing a not-for-profit buyer’s ability to qualify for federal tax-exempt status also need to be considered when determining the transaction structure and purchase price to ensure a buyer can maintain its tax-exempt status.

Structuring a physician practice acquisition transaction to achieve maximum tax benefit involves numerous tax, regulatory and other issues that can impact both a buyer and a seller. For more information on structuring such an acquisition and the associated tax consequences, please contact one of the authors below. The next client alert in this series will focus on practice acquisition valuation considerations.