Analysis of Asset Protection Plans for Physician Practice Groups

by Thomas O. Wells and Nick Jovanovich

As many physicians understand, medical malpractice awards have risen dramatically, insurance premiums have increased exponentially, and a substantial number of medical malpractice insurers have ceased providing insurance in Florida. Between 1995 and 2001, median jury awards in medical malpractice cases doubled from $500,000 to $1,000,000 for the typical case with the maximum annual claim award reported nationwide increasing from $5.3 to $20.7 million over the same period.[1] In 2002, the average medical liability insurance premium for a doctor in Florida was 55 percent higher than the national average. Florida's average insurance premiums have increased 64 percent since 1996, while nationally the average insurance premiums have increased by 26 percent.[2] Fifty-four of the 66 insurance companies have dropped out of the Florida medical malpractice insurance market.[3] The increase in medical malpractice exposure and premiums, coupled with the reduction in insurers in Florida, have caused many Florida physicians either to drop, or consider dropping, their medial malpractice insurance coverage.

Effective September 15, 2003, Florida enacted legislation to limit the noneconomic liability of physicians and physician practice groups, and to "freeze" medical malpractice liability insurance premiums, subject to regulatory approval.[4] However, this legislation does not limit liability attributable to economic damages, does not reduce medical malpractice liability insurance premiums, and does not create more insurance carriers offering medical liability insurance to Florida physicians. Therefore, the medical liability insurance crisis continues after the passage of the Florida 2003 Medical Reform Act.

Asset protection planning for physician practice groups is complex because it requires extensive knowledge of taxation, employment benefits, corporate law, and fraudulent conveyance law.

The purpose of this article is to review the goals of asset protection for Florida physician practice groups and to analyze the costs and benefits of four popular asset protection plans currently available to physician practice groups. These plans generally all involve the physician practice group borrowing funds against its accounts receivables. Simultaneously with such borrowing, the group either: a) distributes the loan proceeds to its shareholders and allows its shareholders to invest the proceeds in asset-protected investments (*e.g.*, annuities, life insurance, homestead property, family limited partnerships, or domestic and/or offshore asset protection trusts) (the "shareholder distribution plan"); b) purchases life insurance policies on each of its physician-shareholders, which policies are then pledged as collateral for a loan to the group, and the group distributes those insurance policies to such shareholders (the "distributed life insurance plan"); c) purchases split-dollar life insurance policies on each of its physician-shareholders (the "split-dollar life insurance plan"); or d) transfers the loan proceeds to a nonqualified deferred compensation plan (a "rabbi trust") that becomes an employee benefit plan subject to ERISA and not subject to the claims of creditors of the group upon some future financial triggering event (the "defensive rabbi trust"). This article will also examine potential fraudulent conveyance liability and corporate "claw-back" liability in connection with this type of planning. Finally, this article will draw some conclusions as to the preferred method of asset protection planning for physician practice groups.

Goals of Asset Protection

Many physician practice groups maintain their books on a cash-basis method of accounting and annually distribute to their shareholders all excess cash either as a dividend distribution or as compensation with a year-end bonus. These

groups have very little equity or net worth on their balance sheet for financial accounting purposes. However, with the delay in payment of accounts receivables by insurance companies and health maintenance organizations of up to 180 days, physician practice groups maintain significant accounts receivable balances that may not be reflected on their cash-basis balance sheet. If these receivables are not pledged to a third party via a security agreement, and perfected as a collateralized interest, they represent assets that may be seized by a judgment creditor (*e.g.*, a plaintiff that obtains a medical malpractice liability judgment against the group). The cash flow provided to the group from these receivables is critical to pay staff and physician salaries, lease payments, and other operating expenses. A judgment creditor can materially disrupt cash flow by notifying all account debtors (*e.g.*, insurance companies and HMOs) to make payments on accounts receivable directly to the judgment creditor and not to the group. This disruption to cash flow could prevent the group from paying its operating expenses or cause the group to cease doing business, or to file bankruptcy to prevent this disruption to cash flow. The cash flow produced by these receivables may also fund physician retirement and physician-shareholder stock repurchase plans.

In light of these factors, the goals of asset protection for physician practice groups are to: a) avoid any disruptions to cash flow derived from accounts receivable by the actions of a judgment creditor; b) ensure that the cash generated from these receivables is available to pay retirement income and make stock repurchase payments to retiring physician shareholders; and c) if necessary, fund start-up costs of a new physician practice group if the prior group becomes liable for a significant medical malpractice judgment and has to cease doing business. These goals are typically addressed with the group: 1) valuing its collectible accounts receivable to establish a borrowing base against these assets; 2) valuing the intangible net worth of the practice either through a discounted net cash flow basis or a discounted capitalization of earnings approach (the "net worth valuation"); and 3) obtaining a loan collateralized by its receivables. Once the group has obtained a loan collateralized by its receivables, the next issue is to address how to utilize such loan proceeds to effectuate the asset protection goals of the group.

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Analysis of Asset Protection Plans

This article analyzes four asset protection plans commonly considered by physician practice groups.

• *Shareholder Distribution Plan*

Under the shareholder distribution plan, the physician practice group distributes the proceeds from the accounts receivable loan directly to the physician shareholders either as a dividend distribution (if the group is a Subchapter S corporation, limited liability company or partnership which will be referred to as a "flow-through entity") or as compensation. Assuming that the group is a cash basis taxpayer and has not recognized any income with respect to its accounts receivable, a dividend distribution of cash in excess of the physician shareholder's income tax basis in his equity interest in the group from a flow-through entity will result in a capital gain to the physician shareholder. Commencing May 6, 2003, the maximum capital gains rate is 15 percent.[5] Assuming that the loan proceeds equal $1,000,000, and are distributed to the physician shareholders as a dividend, and the shareholders have no basis in their stock in the group, the shareholders will have to pay $150,000 in capital gains taxes resulting in net after-tax proceeds of $850,000 that may be invested by the shareholders in asset protected investments and structures.

A non-flow-through entity may implement the shareholder distribution plan by paying its physician shareholders a bonus equal to the loan proceeds. Based on a loan of $1,000,000, which is paid to the physician shareholders as compensation, the shareholders will have additional compensation of $1,000,000, subject to ordinary income tax rates (with the top rate now being 35 percent) and additional employment taxes (with an aggregate top marginal rate of 2.9 percent after $87,900 in compensation for the employer and employee[6]). With a compensatory distribution of $1,000,000, the net after-tax proceeds would be approximately $621,000.[7] This distribution would create a net operating loss for the non-flow-through entity that could offset future income of the group that is created when the group has income and uses such income to make principal repayments. A flow-through entity could use the same compensatory method. In this circumstance, the net operating loss created by the compensation flows to the physician shareholders and may be used to offset future taxable income created by income that is used to repay the principal of the loan. The repayment of the principal of the loan is not deductible and typically creates "phantom" income to the group because the group has income equal to the principal repayment with no corresponding deductions or excess cash to pay the income taxes attributable to such "phantom" income. With a flow-through entity, the net tax cost is the 2.4 percent employment taxes, which

is materially less than the 15 percent capital gains tax applicable to a dividend distribution to the shareholders. Therefore, the compensatory shareholder distribution plan is more tax-efficient than the dividend shareholder distribution plan.

In analyzing the shareholder distribution plan, the group needs to address the corporate "claw-back" provision under F.S. §607.0834[8] and the fraudulent conveyance statute under F.S. §726.106. With the corporate "claw-back" provision, if a dividend is paid to its shareholders that creates a negative net worth for the entity, those shareholders who receive such dividend are individually liable to return such dividend to the corporation, and those directors who approve such dividend, have joint and several liability for such distribution. There is a two-year statute of limitation for this corporate "claw-back" provision. In the example of a $1,000,000 loan made to an entity that maintains its books on a cash basis accounting method, the loan increases assets (*i.e.*, cash) by $1,000,000, increases liabilities by $1,000,000, and has no effect on the net worth of the entity. When the loan proceeds are distributed to the shareholders as a dividend distribution, it decreases the assets and net equity of the entity by $1,000,000 thereby creating potential claw-back liability of $1,000,000 for the shareholders and directors.

Similarly, with the fraudulent conveyance statute, the $1,000,000 dividend distribution can create negative equity of $1,000,000 causing the entity to be insolvent under F.S. §726.103. There is generally a four-year statute of limitations applicable to this potential liability for the recipient shareholders.

To reduce or eliminate potential liability under the corporate "claw-back" provision and the fraudulent conveyance statute, the entity should obtain a valuation of the intangible net worth of the practice using either a discounted net cash flow basis approach or a discounted capitalization of earnings approach. This net worth valuation generally creates net worth for the entity in excess of the dividend distribution to its shareholders. With the net worth valuation, the distribution does not create a negative net worth, thereby eliminating liability under the corporate "claw-back" provision and the fraudulent conveyance statute.[9] Accordingly, a net worth valuation is a critical component of any asset protection planning for physician practice groups.

The major benefit of the shareholder distribution plan is its simplicity. The major drawback is that if the group needs the physician shareholders to return the distributed funds, the shareholders may not have the funds available at the time of a capital call (*e.g.*, bad investments, divorce, or lifestyle expenses), or may retire without returning the funds to the group. Some groups combine the shareholder distribution plan with a cross-indemnification agreement among the shareholders, but, if each of the shareholders has done proper personal asset protection planning, there may be no assets for the group to execute against if a shareholder elects not to comply with the indemnification agreement.

- *Distributed Life Insurance Plan*

Under the distributed life insurance plan, the physician practice group purchases life insurance on each of its shareholders and distributes the insurance policy to its shareholders pursuant to a "deferred compensation" agreement. The insurance policy is then pledged to a lender, which, in turn, makes a loan to the physician practice group that is collateralized by the group's accounts receivable. The purpose of the group purchasing and distributing life insurance policies to its shareholders is to take advantage of Florida law, which allows the proceeds and cash surrender value of the life insurance policies owned by Florida residents to be exempt from the claims of creditors.[10] Many promoters of this plan take the position that the shareholders do not realize any income tax consequences with respect to the distribution of the insurance policy because it is subject to a substantial risk of forfeiture and not transferable under Code §83(a).[11]

There are a number of problems with the distributed life insurance plan. First, it is likely that this deferred compensation plan does not fall within the "top hat" exception to the ERISA rules and regulations and, therefore, is subject to all of the ERISA rules and regulations. The "top hat" exception [12] is for deferred

compensation plans that are designed for a select group of management or highly compensated employees, and that are "unfunded." The Eighth Circuit Court of Appeals has determined that a plan, in which an employer purchased whole life insurance policies for employees, was "funded" for ERISA purposes because the insurance policies were not made available to the general creditors of the employer and the insurance policies created a *res* separate and apart from the general assets of the employer.[13]

As a result of *Dependahle*, the Department of Labor issued Advisory Opinion 81-11A addressing whether the issuance of life insurance policies in a death benefit plan causes the plan to be funded. According to the advisory opinion, the criteria necessary to avoid funding are:

- The insurance proceeds must be payable to the employer.
- The employer must have all rights of ownership under the policies.
- Neither the participants nor the beneficiaries may have any preferred claim against the policies or any beneficial ownership of the policies.
- The employer must not provide any representation to the participants or to the beneficiaries that the employer will use the insurance policies to provide benefits or security for benefits.
- The life insurance policies may not limit or govern plan benefits in any way.
- The plan must not permit employee contributions.

The distributed life insurance plan typically fails several of these criteria. For example, the employee (not the employer) is treated as the owner of the insurance policy under the distributed life insurance plan so that it qualifies under F.S. §222.14 and is exempt from the claims of creditors. In addition, the insurance proceeds are payable to the employee under the distributed life insurance plan, and not to the employer as required by the advisory opinion.

If the distributed life insurance plan is considered "funded," it is subject to the prohibited transaction rules under Code §4975(c)(1)(B) with a tax equal to 15 percent of the amount involved in the prohibited transaction (*i.e.*, the value of the life insurance pledged as collateral for the loan to the group practice if assessed in year one) for each year during which the prohibited transaction occurs, and 100 percent of the amount involved in the prohibited transaction if the transaction is not corrected within the taxable period. The tax is assessed against the group. Also, it is likely that the IRS treats the shareholders that receive these life insurance policies as having current income equal to the value of the distributed life insurance policy less the fair value of the liability secured by the policy.[14] A third problem with the distributed life insurance plan is the internal costs. It typically requires the payment of insurance commissions and the costs of insurance can vary substantially, depending on the age and health of the physician shareholders.

- *Split-Dollar Life Insurance Plan*

Under the split-dollar life insurance plan, the physician practice group purchases life insurance on each of its shareholders. The shareholder owns the policy insuring his life and agrees to repay to the group the amount of insurance premiums paid by the group less the amount of annual term insurance (known as the PS-58 costs), which is treated as compensation to the shareholder. Under the new split dollar regulations, the shareholder has additional compensation equal to the increase in the amount of cash surrender value of the policy to which the shareholder has access.[15]

The split-dollar life insurance plan is not subject to ERISA rules and regulations because it is not a deferred compensation program. However, the shareholder will have to recognize compensation, as noted above. Also, as with the distributed life insurance plan, the split-dollar life insurance plan has internal costs attributable to insurance commissions. Finally, if there is substantial deviation in the ages of the shareholder physicians, there will be substantial variations in the cost of insurance for each shareholder, and it will be difficult to make equal distributions to each shareholder.

- *Defensive Rabbi Trust Plan*

Under the defensive rabbi trust plan, the group deposits the loan proceeds into a rabbi trust. A rabbi trust is a trust that is created to hold funds and to determine the rights of trust participants. The assets of the rabbi trust are accessible to the group's general creditors upon the group's insolvency or bankruptcy. Because the assets of the rabbi trust are accessible by the general creditors of the group, the trust is considered "unfunded" and is not subject to the ERISA rules and regulations or to taxation under Code §83. The IRS has promulgated model forms for rabbi trusts.[16]

The rabbi trust can be terminated at any time by the group. Upon termination, the trust can either distribute all of the proceeds to its participants (which would be taxable) or convert the trust into a secular trust subject to ERISA rules and regulations. If the rabbi trust converts to a secular trust, the participants may defer taxation, depending upon the terms of the secular trust (*e.g.*, vesting requirements, substantial risks of forfeiture and transferability of the participant's account in the secular trust). In Private Letter Ruling 9508014, the IRS ruled that a rabbi trust that terminates when the employer's net worth drops below $10 million is considered "unfunded" upon creation and during the period that it remains a rabbi trust. This type of rabbi trust with a financial triggering event is known as a "springing rabbi trust."

The terms of the defensive rabbi trust provide that the rabbi trust converts into a secular trust upon some future financial trigger (*e.g.*, the net worth of the group drops below $1 million after taking into account the net worth valuation). This event predates any insolvency of the group and minimizes any fraudulent conveyance exposure. In addition, the event is established well in advance of any litigation filed against the group so that the

group is not causing the rabbi trust to convert to the secular trust in an attempt to circumvent, evade, or defeat the claims of creditors (an additional ground for a fraudulent conveyance). This conversion would presumably occur at least 12 months prior to any bankruptcy filing of the group in order to avoid any preference actions that could void the conversion of the rabbi trust to a secular trust. Also, under the rabbi trust, the group is allowed to manage the investment of the proceeds to the trust. This could further minimize the personal exposure of physician shareholders who guaranteed the loan to the group secured by the group's receivables. Finally, upon the maturity of the loan, the group could elect to terminate the rabbi trust and distribute the proceeds to an entity controlled by the physician shareholders. This distribution would be taxable to the physician shareholders and create a corresponding deduction to the group. However, the entity that receives such proceeds could purchase the loan from the bank that originally financed the group's loan and, thereby, acquire a security interest in the accounts receivable of the group.

The benefits of the defensive rabbi trust planning are: a) no ERISA or tax issues upon the creation and initial funding of the rabbi trust; b) the group can manage the investments of the rabbi trust to reduce potential guarantee exposure; c) unlike the distributed life insurance plan or the split dollar life insurance plan, there are no internal costs such as commissions or varying insurance premiums for shareholders with differing ages or health; and d) the proceeds of the rabbi trust may be distributed to an entity controlled by its participants to allow the entity to acquire the security interest in the group's accounts receivable upon maturity of the loan.

Conclusion

Asset protection planning for physician practice groups is complex because it requires extensive knowledge of taxation, employment benefits, corporate law, and fraudulent conveyance law. However, there are some basic tenets in analyzing these plans. First, the group should obtain a net worth valuation to minimize exposure arising from the corporate claw-back and fraudulent conveyance statutes. Second, if the physician practice group is small and the shareholders have a significant level of trust that they will each comply with the cross-indemnification agreement if required, the compensatory shareholder distribution plan is the preferred approach because of its simplicity. Third, with larger groups, the defensive rabbi trust is the preferred approach because of its benefits and, additionally, because of the major disadvantages of the distributed life insurance plan (it is subject to ERISA rules and regulations and results in a prohibited transaction) and the split-dollar life insurance plan (it results in current taxation and internal insurance costs). ☐

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[1] Employment Policy Foundation Study, June 19, 2003, located at www.epf.org/media (cited as "EPF Study").

[2] Study by the Coalition to Heal Healthcare in Florida, May 23, 2003, located at www.healflhealthcare.org.

[3] *See* EPF Study.

[4] Florida 2003 Medical Liability Bill, Ch. 2003-416.

[5] Section 1(h) of the Internal Revenue Code of 1986, as amended (the "Code"), and §301(a)(1) of the Jobs and Growth Tax Relief Reconciliation Act of 2003.

[6] Code §§3101(b) and 1401(b).

[7] This assumes that the payment of compensation is reasonable, and the deduction is allowed. *See Pediatric Surgical Associates, P.C. v. Commissioner*, TC-Memo 2001-81.

[8] Similar statutes also apply to limited liability companies, limited partnerships and professional associations under FLA. STAT. §§608.428, 620.147, and 621.07, respectively.

[9] *See Amjad Munim, M.O., P.A. v. Azar*, 648 So. 2d 145 (Fla. 4th D.C.A. 1994) rejecting the proposition that medical records and patient files have no inherent independent value or goodwill.

[10] FLA. STAT. §§ 222.13 and 222.14.

[11] Treas. Reg. §1.83-3(e) considers the transfer of a life insurance contract as property subject to the rules under Code 2183. The taxation of a split-dollar life insurance arrangement is governed by a separate set of rules under Treas. Reg. 1.61-22. *See* Treas. Reg. §1.83-1(a)(2).

[12] Section 201(2) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

[13] *Dependahle v. Falstaff Brewing Corp.*, 491 F. Supp. 1188 (E.D. Mo. 1980), *aff'd in part, rev'd in part*, 653 F.2d 1208, 2 EBC 1521 (8th Cir. 1981), which provides the following: Funding implies the existence of a *res* separate from ordinary assets of the corporation. All whole-life insurance policies which have a cash value with premiums paid in part by corporate contributions to an insurance firm are funded plans. The employee may look to a *res* separate from the corporation in the event the contingency occurs which triggers the liability of the plan.

[14] *See* IRS Proposed Regulations Reg-164754-01 (May 9, 2003) (the "new split dollar regulations") providing the following: In general, a mere unfunded, unsecured promise to pay money in the future—as in a standard nonqualified deferred compensation plan covering an employee—does not result in current income. However, [an employee's] interest in a life insurance contract under an equity split-dollar life insurance arrangement is less like that of an employee covered under a standard nonqualified deferred compensation arrangement and more like that of an employee who obtains an interest in a specific asset of the employer (*such as where the employer makes an outright purchase of a life insurance contract for the benefit of the employees*). The employer's right to a return of its premiums, which characterizes most equity split-dollar life insurance arrangements, affects only the valuation of the employee's interest under the arrangement and therefore, the amount of the employee's current income.

[15] Treas. Reg. §1.61-22(d)(3)(ii)(A)(1) and (2).

[16] Rev. Proc. 92-64, I.R.B. 1992-33 (July 29, 1992).