IRS Guidelines For Purchasing Medical Practices

BY CHARLES S. GILHAM, JD, LLM

Tax-exempt healthcare providers can find important guidance on physician medical practice acquisition and valuation in the Internal Revenue Service's (IRS's) recently released *Continuing Professional Education Textbook* for fiscal year 1996. The textbook is used by the IRS for training and cannot be relied on as legal authority.

This article highlights the major provisions of Chapter Q, "Valuation of Medical Practices," and alerts readers to the IRS's methods for evaluating the acquisition and valuation of medical practices by tax-exempt healthcare providers.

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Community Benefit Standard

Section 2(D)(4), "The Importance of Valuation Principles in Exemption Determination," discusses the "facts and circumstances" approach based on the IRS's Revenue Ruling 69-545 for determining when healthcare services qualify for exemption under Section 501(c)(3) of the Internal Revenue Code. Under this revenue ruling, an organization must operate exclusively for the benefit of the community rather than private interests in order to qualify for tax-exempt status. This is referred to as the "community benefit standard."

Under the community benefit standard, if an organization pays physicians more than fair market value for their assets, it violates the prohibitions against private benefit and/or private inurement, disqualifying the organization from tax exemption. The IRS has defined fair market value as the price a willing buyer and willing seller agree to when both have reasonable knowledge of the relevant facts and circumstances and neither is under compulsion to buy or sell (Rev. Rul. 59-60). Although the IRS does not determine whether a price constitutes fair market value, it does require applicants for tax-exempt status to establish that the method for determining the price is consistent with the IRS's tax-exemption requirements.

When the acquisition of a physician practice involves unrelated parties bargaining at arm's length, the IRS will generally assume the actual sales price represents fair market value. But the IRS may question the existence of an arm's length bargaining transaction when hospitals acquire practices owned by physicians on their medical staff who continue to provide services through the new affiliation. Under these circumstances, the IRS will look for an unbiased third-party appraisal of the medical practice to determine fair market value.

Valuation Methods

The textbook provides detailed information on three methods for valuing physician medical practices: the cost approach, the market approach, and the income approach.

Cost Approach Under the cost approach the asset's value is measured by determining the cost to replace or reproduce the asset, minus an allowance for physical deterioration or obsolescence. When using this approach to value an entire business enterprise, the parties must use the fair market value of the enterprise's individual assets as a starting point. They then subtract the book value of its liabilities to estimate the business's cost value.

Under the cost approach, the parties can use a number of methods for determining fair market value to create a range of valuations:

- The cost of reproduction (the highest cost value)
- The cost of replacement (the second-highest cost value)
- Actual costs (the next highest cost value)
- Depreciated cost (the lowest cost value)

Market Approach The market approach bases the organization's value on the price paid in the market for similar assets, using actual sales of comparable assets or businesses. However, since no publicly traded physician practices exist and sales information on medical practices is difficult to obtain, the market approach is of limited use in determining the fair market value of a physician practice.

Income Approach The income approach focuses on the discounted cash flow or excess earnings of the physician medical practice. This approach raises

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be open and honest, she said.

Focus on Interests, Not Positions Positions tend to represent deep psychological needs, said Biebel, and this can be confusing, even to the person taking the position. For example, she explained, a worker asking his boss for a raise should decide beforehand whether he primarily wants the raise for the actual money involved, for recognition, or perhaps for some other reason. Negotiators who are unclear about their interests are likely to meet frustration and deadlock, she said, but those who understand their own motives may accept more than one solution.

Generate a Variety of Options The demands of clear-headed negotiators can be met in a variety of ways, which Biebel called "currencies." Thus a cash-strapped boss might offer his worker a more prestigious title or a company car instead of a salary increase. Skilled negotiators are creative with their currencies. In fact, she noted, really good ones approach negotiations as if they were games.

Insist That the Result Be Based on Some Objective Standard On the other hand, Biebel said, negotiations can be tense even for skilled players, so players should be specific about the particular currency they are discussing. By naming some objective criteria—a salary increase, say, or a new job title—negotiators depersonalize the negotiating process and relieve the tension involved in it. *—Gordon Burnside*

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the possibility of overvaluing the practice if income projections are not consistent with the current and future market conditions in the area. Consequently the IRS will scrutinize valuations based on the income approach for consistency with market realities.

Valuing Intangible Assets Section 6(J) of the textbook analyzes the valuation methods for several common intangible assets found in a medical practice: goodwill, medical records, assembled work force, going concern value, covenants not to compete, managed care contracts, and trade names. The IRS suggests using the cost approach to value intangible assets such as medical records, assembled work force, and computer software. It recommends the income approach for valuing goodwill, noncompete covenants, managed care contracts, and trade names.

Allocation Technique The allocation technique values assets according to the most appropriate method, rather than rigidly applying only one method. The allocation technique values assets under either the cost or market approach whenever possible, but uses the income approach when the assets are not subject to valuation under either of those approaches. The figure obtained by the aggregation of all these variables becomes the value of the enterprise. The IRS indicates that using this technique to allocate the asset value of a medical practice results in verifiable information that facilitates an IRS review.

The IRS's level of knowledge and sophistication are rapidly increasing with respect to modern healthcare and integrated delivery issues. The textbook is an example of how IRS agents will analyze transactions involving the purchase of physician medical practices by tax-exempt hospitals. Managers, financial staff, and legal counsel for these healthcare organizations should refer to the textbook for guidance when planning to purchase a medical practice. □