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# WHAT GOES AROUND COMES AROUND: *DERBY ET AL. V. COMMISSIONER*

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*Established health care valuation principles from the 1990s remain in full force and effect according to Mark Dietrich, CPA/ABV, founder of Mark Dietrich, CPA, PC, and author of the following article. Mark is coeditor and author of several chapters on medical practices and regulatory matters in Business Valuation Resources'* The Complete Guide to Healthcare Valuation, *scheduled for publication in the fall of 2008. He is also a member of the editorial advisory board of* CPA Expert. *You can access his blog at* http://cpanet.typepad.com.

The Tax Court case *Derby et al v. Commissioner*[1] is important for a variety of reasons, not the least of which is its instructive value as today's consolidation in the health care industry mirrors that of the early and mid-1990s when the *Derby* case originated. Key factors in the case include those which this author has repeatedly cited in numerous articles over the last 10 years in *CPA Expert*, the *Journal of Accountancy*, and other professional publications. Those factors are as follows:

1. The use of expected posttransaction physician compensation in the discounted cash flow model based on the transaction documents *rather than* the use of some arbitrary compensation figure, such as the median compensation for a given physician specialty
2. Allocating enterprise or invested capital value among working capital, fixed assets, and intangible assets
3. Carefully studying transaction documents to discern the character and extent of any intangibles being transferred or not being transferred
4. The critical import of allocating between personal/professional goodwill and enterprise goodwill when valuing a medical practice for acquisition by a hospital
5. The importance of any noncompete agreement in determining the value of the medical practice, and the import of *Norwalk v. Commissioner*
6. The need for "donative intent" when claiming a deduction for the value of a medical practice, or other enterprise allegedly donated to a tax-exempt entity
7. The relevance of the Friendly Hills private letter ruling and the 1994 *Exempt Organizations Continuing Professional Education Technical Instruction Program Manual*
8. The citation of the Anti-Kickback Statute (AKS)
9. The issue of the timeliness of the valuation versus the date of the transaction

The *Derby* ruling highlights the typical issues in the valuation of a physician

1 *Charles A. and Marian L. Derby, et al., 1 Petitioners Commissioner*, Respondent, T.C. Memo. 2008-45, Judge Gale

practice for sale or other transfer to a hospital or integrated delivery system. As such, Judge Gale's words are frequently quoted and set off.

## CASE SUMMARY

The case arose out of a claimed charitable deduction for the intangible value of the medical practices of more than a dozen physicians who sold their practices to Sutter Medical Foundation (Sutter) in 1994. The purchase agreements contained payments for fixed assets, while the selling physicians retained their accounts receivable.

The transaction took place during the period of consolidation of the health care industry that was associated with the rise of managed care and capitation on the West Coast in the early 1990s and which later spread across the country. Although restrictive managed care and capitation have fallen into disfavor and have lost market share over the last six or seven years, consolidation is once again the rage in health care. And although some markets, such as Boston, are reconsidering the use of capitation, much of the present consolidation is driven by the more typical revenue concerns associated with fee for service medicine. Major hospital and ancillary testing sources of revenue, such as cardiology, orthopedics, and high tech imaging, are driving many of today's transactions.

The key decisions for the court were whether, in fact, there had been a *donative* transfer of intangible value, what the value was, and, *if* the claimed value of the donation was overstated, whether the donor-physicians were subject to understatement or overvaluation penalties. As such, the court carefully scrutinized the valuations submitted by the taxpayers in connection with the donation received.

Critical to the ultimate resolution of the donation issue was a review of the history of the transaction with Sutter, which had declined to *pay* anything for intangible value, citing the AKS, which is the Medicare and Medicaid Patient Protection Act of 1987, as amended, 42 U.S.C. §1320a-7b. The AKS provides for criminal penalties for certain acts that affect Medicare and state health care (for example, Medicaid) reimbursable services. Sutter also cited the "famous" Thornton Letter in which the then Deputy Counsel of the Office of the Inspector General stated that a sale of goodwill by a physician to a hospital was problematic. Peter Grant, legal counsel in the seminal integrated delivery system transaction of the 1990s, represented the *Derby* physicians, known as the Davis Medical Group (DMG).

> Unlike Foundation, Sutter Health was unwilling to pay anything for the intangible assets, or goodwill, that might be associated with petitioners' medical practices.... First, and principally, because Sutter Health's management believed that doing so might constitute a crime under the Medicare and Medicaid antikickback statute, 42 U.S.C. sec. 1320a-7b(b), prohibiting payments for referrals of patients eligible for Medicare or Medicaid; and second, because Sutter Health's management believed, on the basis of their projections of the financial performance of the UHMG [University Health Management Group] physicians' group after acquisition, that any additional payment for intangibles would have rendered the deal financially nonviable for Sutter Health.
>
> Mr. Grant recommended that petitioners structure the transfers of the intangibles as donations because that technique had been used in connection with an acquisition of a group medical practice by a nonprofit medical foundation (*Friendly Hills Healthcare Foundation*), for which Mr. Grant had served as an adviser. Mr. Grant was familiar with the annual *Exempt Organizations Continuing Professional Education Technical Instruction Program manuals*, including the manual for 1994...[emphasis added].

## TRANSACTION OVERVIEW

The parties retained Houlihan Lokey (Houlihan), the valuation firm in the Friendly Hills transaction, which arranged for an appraisal of the "business enterprise value" defined in the following text. Note the emphasized items.

> [T]he fair market value of the aggregate assets of [the Davis Medical Group] *exclusive of any*

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> *benefit or element of value conferred upon Sutter* [Health] as a consequence of its current or proposed relationship with * * * [Davis Medical Group][2], and *with consideration of proposed post-transaction compensation and benefits to the physician group.*

Houlihan also agreed to "allocate the appraised value … to each of its physician/shareholders" using a method to be agreed upon in consultation with the [physician] steering committee, but the agreed-upon method "[had to] be acceptable" to Houlihan.

Sutter West Medical Group (SWMG) entered into a professional services agreement (PSA) or employment contract with Sutter as part of the transaction.[3] The court spelled out the key economic terms of the PSA, which included a very limited noncompete—the terms of which are critical in this valuation and, for that matter, any such valuation—and a complex revenue sharing formula that included a minimum compensation guaranty. The PSA also contained what amounted to a signing bonus that the court would see as, in part, a payment for goodwill.

> The PSA contained a noncompete provision, under which SWMG and its physician shareholder/employees were prohibited from participating in the ownership, management, operation, or control of any business or person providing health care services within the service area covered by the agreement. However, specifically exempted from this prohibition was any SWMG physician who left the employment of SWMG.… Departing Physician may give written notice to the Departing Physician's patients named in the Departing Physician's patient list furnished to SMF [Sutter Medical Foundation] on or before the… Effective Date…, announcing the Departing Physician's separation from * * * SWMG and his or her new practice location, and offering the patient an opportunity to choose whether his or her patient records should remain with SMF or be transferred to the Departing Physician.
>
> To provide an incentive to SWMG to form and sustain a group, SMF will pay SWMG a Physician Access Bonus…. The Physician Access Bonus was $35,000 for each of SWMG's full-time physicians.

The transaction documents stated that the seller and buyer believed the purchase price was less than the fair market value and that the difference was being donated. Significantly, the document contained a provision requiring that the appraisal be completed within 60 days—designed to avoid a "stale" valuation. Finally, a discounted cashflow model was used. All of the factors outlined in the case closely track the Friendly Hills private letter ruling and the 1994 *Exempt Organizations Continuing Professional Education Technical Instruction Program Manual.*

As previously discussed, the donation was to be allocated among 29 physicians who formed the group practice based on the valuation. In actuality, the donation was allocated using a formula designed by one of the physicians, which attributed "(i) 50 percent of the aggregate value on the basis of each physician's share of gross revenues generated in the year preceding the transfer to SMF; (ii) 25 percent on the basis of each physician's 'years in the community,' with up to a maximum of 5 years being counted; and (iii) 25 percent on the basis of each physician's share of the aggregate fixed assets transferred to SMF by the SWMG physicians." Although the physicians attached a form 8283 to their tax returns, Sutter never reflected the donation in its tax return—despite the transaction documents obligating it to do so.

## TAXPAYERS' VALUATION FOR TRIAL

For health care industry appraisers and valuation analysts, the issues surrounding the appraisal submitted for trial are the most important. Perhaps the most significant feature of the appraisal prepared for the trial was the use of median compensation for the physician-sellers rather than the actual compensation negotiated in the transaction! This remains an item of ill-considered debate and frequently results in mistaken assumptions in physician practice and other professional practice valuation, despite being long-settled and in direct conflict with fair market value.[4] The question can be stated as follows: Would the hypothetical buyer pay a price for the practice based on a *lower* compensation than they intended to pay posttransaction, thereby paying twice to the extent of the extra compensation?[5]

> …the national median for the 'Western Region' for a weighted average of the medical specialties comprising SWMG, or 45.18 percent in determining the physician compensation expense for the discounted cashflow model.[6] *However, the actual compensation negotiated in the transaction 'provided for compensation to SWMG equal to 57.75 percent of fee-for-service revenue, 47 to 53 percent of capitation revenue, and at least 55 percent of risk pool revenue.' [Emphasis added].*

The appraisal of Ernest E. Dutcher, managing member of National

2 Davis Medical Group later changed its name to Sutter West Medical Group (SWMG).
3 This is a standard feature of purchase transactions.
4 See, for example, "Medical Practices: A BV RX," *Journal of Accountancy*, November 2005.
5 Besides the inurement risk under the Internal Revenue Code, this error creates risk under the AKS and Stark laws.

Business Appraisers, contained other significant weaknesses in the view of the court. There was no allocation of any intangible value to the professional goodwill of the physicians,[7] as opposed to enterprise goodwill, which the court differentiated as follows:

> … no allocation of any value to the professional goodwill of the SWMG physicians despite the fact that Mr. Dutcher distinguishes, in the case of the goodwill of a professional practice, between 'practice' goodwill and 'professional' goodwill, the former attributable to characteristics of the practice entity such as patient records, provider contracts, and workforce in place; and the latter attributable to the personal attributes of the individual practitioner, such as charisma, skill, and reputation' and he acknowledge[d] that professional goodwill is not transferable.

Dutcher's testimony that professional goodwill is not transferable would have been one of many fatal blows to the taxpayers' position. The court went on to discuss the lack of noncompete agreements and importantly emphasized the continuing viability of *Norwalk v. Commissioner*,[8] perhaps the seminal case on the ownership and valuation of personal goodwill and noncompetes. A noncompete is the contractual basis for transferring personal or professional goodwill to an employer. The court also observed that the willing buyer would have insisted on "a significant discount" due to the lack of a noncompete!

> There is no adjustment for the fact that the SWMG physicians were not required to execute noncompete agreements. Mr. Dutcher treated each SWMG physician as transferring an allocable share of SWMG's intangibles, including goodwill, which was not treated as diminished in any way by the physicians' not having executed noncompete agreements with respect to SWMG or SMF. However, in *Norwalk v. Commissioner*, T.C. Memo. 1998-279, we found that there is no transferable or salable goodwill where a company's business depends on its employees' personal relationships with clients and the employees have not provided covenants not to compete…We also believe that, under the willing buyer/willing seller standard of fair market value… a willing buyer of SWMG on the transaction date would have insisted on a significant discount with respect to the value of the entity's intangible assets, precisely on account of the absence of noncompete agreements from the SWMG physicians.

Other problems cited by the court included the taxpayers' use of an intangible value allocation model developed by one of the taxpayers rather than one based upon sound appraisal techniques and the taxpayers' failure to include in the valuation any consideration of the $35,000 signing bonus described previously.

## THE DONATION

A fundamental requirement in a charitable transfer is that the contributor have "donative intent" in order to receive a tax deduction. Donative intent contemplates a disinterested gift to a charitable organization without the donor receiving any corresponding benefit. It remains commonplace to attempt to structure physician practice transfers as part-sale, part-donation in the current environment.

> In its analysis of the transaction, the court found that the taxpayers received significant benefits from the transaction, which belied any intent to make a disinterested donation with no consideration in return. The court cited the advantages of patient retention, negotiating leverage as part of a larger system, and compensation based upon a percentage of net revenue, all of which were embodied in an employment contract with 'carefully delineated terms.'

## CONCLUSION

Consolidation trends are cyclical, and the wave that collapsed 10 years ago in the health care industry is back again. *Derby* reminds us that the old adage, "Those who fail to learn from history are doomed to repeat it," remains in full force and effect. From the standpoint of the hypothetical buyer, the court reiterated old guidance with respect to the common sense requirement that the value of the practice be based on expected posttransaction compensation. Equally important, the court restated the principles espoused in the *Norwalk* case that contracts—in this case the purchase and sale and PSA—be part of the analysis of intangible value because of the effect of any noncompete agreements. Thus, when valuing a medical practice for purposes of an actual transaction, the appraiser must be familiar with the terms of that transaction if the buyer and seller are to rely upon it for regulatory purposes. As the court seemed to suggest about the appraisal submitted by the taxpayers in this case, something other than that which the parties transacted was valued. Transactional valuation *requires* understanding the terms of the transaction in order to opine on fair market value.

6 The phrase "national median for the 'Western Region'" appears to be a misnomer. The data were taken from the MGMA Physician Compensation Survey 1994 "Report based on 1993 Data"

7 "Identifying And Measuring Personal Goodwill In A Professional Practice," *CPA Expert*, Spring 2005 and Summer 2005.

8 T.C. Memo. 1998-279; See "Goodwill Requires Enforceable Covenant Not To Compete," *CPA Expert*, Spring, 1999.