

PHYSICIANS CAUGHT IN THE ENRON NET

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The Setup.

Someone cooks the books. The insiders come away with millions of dollars. The investors are left holding the bag. Whether this is Enron or Worldcom, the last ten years has been fraught with corporate corruption and financial shakedowns of common investors. Executive compensation packages have long included stock options and deferred compensation plans in order to compete for executive talent. When things start going bad with the companies that these executives are directing, the executives ensure that their benefits are well protected while the company, its creditors and investors may be abandoned.

The Trap.

Just as dolphins get caught in a tuna fisherman's net, last year Congress cast a net on corporate executives that can entrap physicians. The newly enacted Section 409A of the Internal Revenue Code became law on January 1, 2005 and applies to any type of arrangement that defers income (other than a qualified pension or profit sharing plan). This poses a dilemma for most medical practices. Because the scope of the statute is not restricted to publicly-held companies, physician practices must also comply or face severe penalties. These penalties could include an immediate taxation of accounts receivable, a surtax equal to an additional 20% of this amount, and interest. If a practice has \$1 million of accounts receivable and even inadvertently fails to comply with this new law, the result could be taxes, interest and penalties exceeding \$700,000!

The Bait.

A typical physician entity will have incremental ongoing changes of ownership as the physicians become owners and then, alternatively, retire. Most physician entities pay out accounts receivable as deferred compensation at the time of leaving the entity. Therefore, these physician entities would have "deferred compensation plans" under Section 409A where the amount of the benefit is measured by the balance of accounts receivable at the time of leaving the practice.

The Typical Dolphin Caught in the Tuna Net.

Unsuspecting Medical Clinic is equally owned by Drs. A, B, and C. Unsuspecting has \$120,000 of accounts receivable and if any or all of Drs. A, B, and C were to leave the practice, each would be paid one-third (1/3) of this amount, or \$40,000. Dr. D was hired two years ago out of residency and is about to become an owner of Unsuspecting Medical Clinic. Dr. D will acquire a deferred compensation benefit equivalent to an equal portion of the accounts receivable. This \$30,000 benefit (i.e., $\$120,000 \div 4$) will require his deferral of \$30,000 during the course of the following year or years. The \$30,000 will result in \$10,000 of additional income to each of Drs. A, B, and C to compensate them for their drop in their deferred compensation benefit.

The Net.

New Section 409A presents various issues that are somewhat unique to a physician entities:

1. New Owners Added. When Dr. D acquires his \$30,000 deferred compensation benefit in the example above, Drs. A, B, and C each receive \$10,000. Because each of their deferred compensation agreements stipulate that their benefit is measured by the value of the accounts receivable divided by the number of employees that share in this benefit, their amount decreases by virtue of the operation of the formula. Drs. A, B, and C are receiving more additional compensation than would otherwise be the case had Dr. D not become an owner, and therefore could be deemed to be receiving a distribution of deferred compensation. If the \$10,000 to each of Drs. A, B, and C is characterized as a distribution of a deferred compensation benefit, it would violate the new law and result in the entire \$120,000 to be taxed with the 20% penalty.
2. Shrinkage of Accounts Receivable. Because the Unsuspecting Clinic deferred compensation benefit is measured by the accounts receivable divided by the number of physicians, this benefit decreases when the value of the accounts receivable drops. This drop could be due to a variety of factors including a lower volume in their practice or improved collection experience in their billing office. If the accounts receivable go from \$120,000 to \$100,000, then each of Drs. A, B, C, and D have a reduction in their benefit (if they were to terminate their employment with Unsuspecting Medical Clinic) from \$30,000 to \$25,000 (i.e., $\$100,000 \div 4$). A shrinkage in value of accounts receivable from \$120,000 to \$100,000 results in an additional infusion of \$20,000 of cash flow during the year that gets paid out as current compensation to the physicians and results in higher current income for the year. Receiving a higher current income coupled with a decline in their deferred compensation benefit could be construed as a distribution of their deferred compensation benefit. If deemed a distribution, then the deferred compensation plan of Unsuspecting Medical Clinic would fail the distribution requirements under the new law.
3. Payments in the Event of Disability. Most practices would provide that some sort of salary continuation could occur in the event a physician is unable to perform his or her duties. If the physician then terminates employment, there would be an offset of such salary continuation against the deferred compensation benefit (so the practice is not paying this benefit twice). The existence of an offset against the deferred compensation benefit could result in the conclusion that it is in fact a distribution of that benefit. If it is a distribution of the deferred compensation benefit and the professional cannot meet the “disabled” definition found in the new law because the impairment is not expected to last for at least 12 months, then the distribution would be in violation and everyone in the practice would be penalized under the new law based upon the full value of accounts receivable.

No Catch and Release.

New Section 409A imposes devastating consequences for the failure to comply. While an IRS Notice issued early this year provides comfort that good faith and reasonable interpretation will shield taxpayers from being penalized under this statute until further guidance is provided, the statute itself does not have a “materiality requirement” to it. Therefore, if a plan has a failure at any time in its operation, regardless of materiality, that runs afoul of published guidance by the IRS, all of the penalties immediately apply. There seems to be the potential for an infinite

variety of innocent situations where technical violations may occur and can be corrected with no harm or are not material. There is no opportunity for relief for a technical, nonmaterial failure even if corrected.

Escape Strategies.

1. Eliminate the Net. The author of this article submitted comments to the IRS suggesting legislation or regulations to amend Section 409A to allow for a specific exception for entities engaged in a profession and 100% owned by those professionals.
2. Eliminate the Bait. The issues arising under the new law are based upon the existence of deferred compensation plans in physician practices that fluctuate with changes in ownership as well as changes in the balance of accounts receivable. Therefore, there are various changes that these practices could consider in order to avoid the risks under the new law:
 - a. Freeze All Deferred Compensation Benefits. This would involve setting the dollar amounts for each physician employee owner regardless of the balance of accounts receivable at the time of leaving the practice and regardless of the existence of a disability. No offsets and no fluctuations. If this approach were adopted, then care should be taken in the current compensation formula to ensure adequate eventual funding of this benefit if the accounts receivable are in fact shrinking. Likewise, new shareholders of the physician practice may or may not accrue a deferred compensation benefit.
 - b. Accounts Receivable in Stock Value. Even though this approach has long been avoided because of its tax inefficiency, the treatment of accounts receivable as all other assets of the practice could be rolled into the value of stock in the practice. This would avoid deferred compensation altogether.
 - c. Creation of New Deferred Compensation Plan. The physician practice could develop a whole new concept for deferred compensation which is integrated with current physician compensation as well as stock value. This new plan would be designed to be in compliance with the new tax law and therefore would not vary with levels of accounts receivable.

Roaming the Waters.

The IRS has indicated a tolerance for activity in 2005 prior to guidance being issued where there is a good faith attempt to comply with the new law. Care should be taken with circumstances that result in changes in deferred compensation benefits such as the addition of new owners and payouts for retirement or disability. Once the guidance is issued, then each practice should assess its plan against the application of the new law.

With this planning and favorable guidance from the IRS, physicians should be able to swim freely without fear of the Enron net.

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