OUTLINE OF BUY-IN AND BUY-OUT ARRANGEMENTS FOR MEDICAL PRACTICES

I. Shareholder Admission

A. General Concepts

1. The buy-in typically consists of two components, namely a payment for stock and a buy-in to receivables.

2. Some groups have the shareholders, as opposed to the Corporation, sell stock to the new shareholder. This alternative allows the current shareholders to receive the proceeds of the sale of stock as capital gains rather than ordinary income to the extent the proceeds of the corporate sale of stock are distributed by the Corporation to the current shareholders.

3. The new shareholder's buy-in into receivables can be done on a pre-tax or post-tax basis. If done on a pre-tax basis, a portion of the new shareholder's salary or "discretionary" bonuses are reallocated to the other shareholders for a period of years. If done on a post-tax basis, the new shareholder uses after-tax dollars (i.e., W-2 income) to buy into receivables.

4. Some groups do not make a physician a shareholder until the physician's buy-in into receivables is completed. This is accomplished by paying less compensation to such physician while a nonshareholder employee. This approach has the effect, of a pre-tax buy-in.

5. As an alternative, the accounts receivable can be allocated to the current shareholders, thus eliminating the buy-in to receivables. However, the Corporation will need an alternative source of cash to provide interim cash flow for overhead because collections of such accounts receivable technically will be allocated to the current shareholders. The Corporation could take out a line of credit, borrow from the current shareholders, defer payment of such collections to the current shareholders or some combination of these alternatives.

6. The economic terms of the buy-in should be consistent with the terms governing the buy-out.

B. Receivables Buy-In

1. The buy-in to receivables is based on the value of the new shareholder's "share" of accounts receivable. The shareholder's "share" is dependent, in large part, on the group's compensation formula. For example, if it is an "eat what you kill" system, the shareholder will be buying his/her own

accounts receivable. If the group's compensation is divided equally, the new shareholder will be buying his/her pro rata share of the Corporation's accounts receivable.

2. In addition, adjustments to the buy-in number may need to be made. For example, if the new shareholder's actual collections while a nonshareholder exceeded the nonshareholder employee's salary, benefits and share of overhead, computed the same way as for the shareholders, the difference should be credited against the new shareholder's buy-in to accounts receivable. If the new shareholder, while a nonshareholder employee, was paid a fixed salary plus participated in the bonus pool because the nonshareholder employee's production was high enough, then credit should be given for that portion of receivables that the bonus was based on. For example, if the new shareholder, while a nonshareholder employee, was eligible for a bonus of 50% of his/her production that exceeded a certain threshold, the new shareholder would be considered to "own" half of those receivables that exceeded the threshold and would only need to "buy" the other half.

C. Stock Purchase

The options for valuing the stock to be purchased include the following:

1. <u>Arbitrary Number</u>. An arbitrary number is set for the value of the stock such as its par value or some other number.

2. <u>Book Value</u>. The purchase price of the stock is based on the Corporation's net book value as calculated by the Corporation's accountants.

3. <u>Adjusted Book, Value</u>. This option is the same as the book value option except that the fair market value of the Corporation's personal property, is substituted for its depreciated value.

4. <u>Greater Of</u>. The purchase price of the stock is the greater of par value or book/adjusted book value.

II. Shareholder Exit

A. General Concepts

1. The terminating shareholder receives accrued but unpaid compensation generally calculated pursuant to the formula used to calculate compensation on an ongoing basis, termination pay (termination pay or severance pay), and payment for his/her stock.

2. Accrued but unpaid compensation is paid in accordance with Corporation's normal payroll practices.

3. Termination pay is typically paid out over a period of one to two years, without interest.

4. Termination pay is often reduced to account for certain factors.

5. The purchase price of the stock is paid in a lump sum within 60-90 days following date of termination.

B. Termination pay

The options for calculating the termination pay payable include the following:

1. Actual Collections: The terminating shareholder receives a percentage of his/her accounts receivable that are collected for a set period of time after termination. Any remaining accounts receivable after the set period of time has expired are retained by the Corporation. The percentage of accounts receivable retained by the Corporation is to cover the billing and collection overhead.

2. Set Value: A value is established for the termination pay based on the terminating shareholder's "share" of accounts receivable on the books as of the effective date of termination, adjusted to reflect contractual adjustments, bad debt and historical collection experience. The terminating shareholder's "share" can be based on production, number of shareholders, compensation, or some other method. The amount arrived at is then paid out over a period of time which typically is one to two years. Under this objective, the Corporation bears the risk or reward of actual collections experience but does not need to account to the terminated shareholder as to periodic collections.

C. Termination pay Adjustments

The termination pay payable is typically increased to account for the following:

1. Allocation of Nonvested Amounts: The termination pay is increased by the shareholder's "share" of the unpaid amount of a non-terminating shareholder's buy-in to accounts receivable, but including only the "unvested portion" of those physicians who became shareholders after the terminating shareholder.

2. Allocation of Nonshareholder Amounts. Some groups increase termination pay to include the terminating shareholder's "share" of the accounts receivable generated by nonshareholder physician employees, physician assistants and nurse practitioners.

D. Termination pay Reductions

The terminating shareholder typically does not receive 100% of their interest in accounts receivable. Adjustments that are commonly used to reduce the termination pay payable include the following:

1. Insufficient Notice. A reduction is often made for failure to give sufficient notice of voluntary termination. For example, the employment agreement gives the employee the ability to terminate the employment agreement upon 90 days' notice and he/she gives the Corporation 60 days' notice. The reduction is made on a pro rata basis. In the example above, the terminating shareholder's termination pay would be reduced by one-third.

2. Overhead. Many groups reduce termination pay by a portion of the Corporation's fixed overhead to be incurred after termination. The reasoning behind such is to acknowledge that it will take awhile to replace the terminating shareholder yet the Corporation will continue to have fixed costs such as rent. This reduction typically does not apply in the event of death, disability, retirement or termination of the shareholder's employment by Corporation, without cause.

3. Excess Liabilities. If the Corporation has a negative book value, some groups reduce the termination pay by the terminating shareholder's pro rata share of such amount. The reduction, however, does not require the shareholder to contribute anything to the Corporation in excess of the value of his/her termination pay and other amounts owed to the shareholder by Corporation.

4. Incomplete Buy-In to Receivables. If the physician is made a shareholder prior to the time the buy-in to receivables is complete, such physician's termination pay is reduced by the unpaid portion to eliminate a windfall to the departing shareholder, who, but for the forfeiture provision, would leave prior to completing the buy-in to receivables but receive 100% of the termination pay account without having paid 100% into receivables.

5. Covenant Not to Compete Violation. If the Corporation has a restrictive covenant in its employment agreement, a violation will typically require forfeiture of the termination pay. Groups often use the reduction to termination pay for overhead in lieu of a covenant not to compete due to enforceability issues of such covenants.

E. Tax Treatment of Termination pay Payments

1. Income Tax Withholding. The termination pay payments are subject to income tax withholding at the time of payment. Accordingly, if the termination pay is paid in installments, income tax must be withheld from each installment. Due to the fact that the termination pay is an unsecured liability, i.e. the shareholder is an unsecured general creditor of the Corporation, constructive receipt of the total amount due is avoided thereby deferring the income tax payable/withholding until the time each installment is made.

2. FICA. The termination pay payments are subject to FICA taxes when no longer subject to risk of forfeiture. This occurs when the shareholder's right to receive the termination pay becomes fixed, i.e., the effective date of the shareholder's termination of employment, even though the amount may be payable in installments or the amount is unknown at the time of termination because the shareholder receives a percentage of accounts receivable collected for a period of time after termination of employment. The termination pay amount may escape FICA taxes if the shareholder's other earnings from the Corporation exceed the FICA taxable wage base for the year of termination of employment. When the termination pay is actually paid, the payments are not again subject to FICA taxes.

3. Medicare. The rules for Medicare taxes are the same as for FICA. However, since the Medicare tax base is unlimited, Medicare taxes would need to be withheld on each termination pay installment.

4. Qualified Plans. The termination pay is not considered "compensation" for purposes of the Corporation's qualified retirement plans.

F. Stock Value

The options for valuing the stock to be redeemed include the following:

1. Arbitrary Number. The purchase price of the stock would be an arbitrary number such as its par value or some other number.

2. Book Value. The purchase price of the stock is based on its pro rata share of the Corporation's net book value as calculated by the Corporation's accountants, excluding accounts receivable. If net book value is a negative number, the terminating shareholder typically would be required to "contribute" his/her pro rata share of such negative value but only to the extent of monies owed to the terminating shareholder such as salary and termination pay.

3. Adjusted Book Value. This is the same as the book value option but under this option, the fair market value of the Corporation's personal property is substituted for its depreciated value.

4. Greater Of. Some groups base the value of the stock on the greater of its par value or the arbitrary value as compared to book value. The reasoning behind "the greater of' language is to avoid possible reluctance of older shareholders to allow the Corporation to use cash that would otherwise be distributed as bonuses to make equipment and similar capital purchases, as, theoretically, the capital purchases would increase book value with the retiring shareholder receiving his "bonus" via an increase in the stock value.

G. Tax Treatment of Stock Redemption.

1. Shareholder. The proceeds from the sale of stock are taxed as capital gains to the shareholder.

2. Corporation. The purchase price of the stock is not deductible by the Corporation. Although this may cause the shareholders to think about buying the stock, they too, cannot deduct the purchase price and would be paying for the stock with after-tax dollars. However, it does create basis for them.

III. Transition/Fairness Issues for Current Shareholders

1. Grandfather Provision. Those close to retirement or who have a certain number of years of service with the Corporation could have the ability, upon termination of employment, to select the method (i.e. current method or new method) that provides them with the most dollars.