legal matters

Receivables at Risk

What can you do to protect the valuable asset of your accounts receivable from a lawsuit? It's not as easy as some advisers would have you believe, but it can be done.

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At a recent medical conference, we heard a physician presenter joke that if you asked a group of 10 doctors about anything, you would get 11 different opinions—one had multiple personalities. All kidding aside, the difficulty in getting the members of a medical group to agree on anything is great. However, there is one thing all doctors do agree upon: No doctor in the group wants his future income to be at risk to the mistakes of another physician in the group. It is bad enough that you have to pay escalating malpractice premiums and attend asset protection seminars (we know you do because we give 50 of them annually) just to protect yourself from your own potential or perceived mistakes.

The last thing any doctor wants is for his partner's malpractice to wipe him out financially. How can this happen? Consider what happens in any lawsuit. All doctors involved, along with their group practices, are named in the lawsuit. If the lawsuit judgment is in excess of coverage limits, because of "joint and several liability" all of the defendants are responsible for paying the amount above the typical $1,000,000 coverage. In 2002, there were two cases against ob/gyns that ended in judgments over $80 million. The attorneys only get paid if and when their clients collect. So, the attorneys are going to take the "low hanging fruit." They go after the easiest money to collect. The easiest money to collect is:

If the lawsuit judgment is in excess of coverage limits, because of "joint and several liability" all of the defendants are responsible for paying the amount above the typical $1,000,000 coverage.

1. Unprotected (from an asset protection standpoint) brokerage accounts of the defendants
2. The accounts receivable (A/R) of the practice

Of course, once the A/R is taken from the practice to satisfy a judgment, all of the physicians in the group who weren't responsible for the loss have the right to sue the doctor who committed the malpractice action. But, after a big judgment, that doctor won't have any money left. The end result: The group's A/R will be gone and the innocent members

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of the group will not get paid for at least two to four months. In addition, the partners of the group will have to use their personal funds to pay the salaries and overhead of the practice. This is a nightmare for most physicians.

So, what can you do to protect your accounts receivable? In this article, we will discuss one strategy that can achieve asset protection and at the same time, possibly enhance the participating physician's retirement benefits and lower her current tax liabilities. What is this strategy? It is leveraging A/R into a tax-deferred, asset-protected retirement plan. Let's see how it works.

What is "A/R leveraging?"

From the many programs we have reviewed for physicians, we can say with experience that not all programs are the same. Nonetheless, the first part of the transaction is always the same—the practice gets a loan, pledging the A/R as collateral. With the funds in hand, the practice then invests the funds in a tax-deferred, asset-protected investment that will not be exposed to the practice's creditors. Ideally, this is done in a way that does not create a present tax liability to the physicians (many programs fail in this area). Then, the investment grows on a tax-deferred basis, ultimately being used to pay off the debt upon retirement and using the additional funds in the program to enhance the physicians' retirement benefits. Before we get into how to protect your A/R the right way, let's look at all of the mistakes that physicians make when trying to protect the A/R.

A/R leveraging the wrong way

While there are many variations on the theme, the typical "wrong" A/R financing strategy works like this: The practice takes the loan proceeds and funds a "deferred compensation plan" for the physicians. The interest on the loan is allegedly tax-deductible, making the financial "cost" of the loan 40 to 50 percent less than if the interest were paid with taxed money. As part of the deferred compensation plan, the practice buys annuities or a life insurance policy on the physician's life. The lender takes a security interest in the policy/annuity also.

The practice either transfers the annuity or policy to the physician, retaining some nominal rights in the annuity/policy (or allows the doctor to take loans out of the annuity or policy directly). When the physician retires, she liquidates the annuity/policy, pays the practice the loan principal back, which then pays off the lender. The doctor takes the remaining balance and pays tax on the money only at retirement, if at all (or so they promise).

Let us say here, in short, that we do not believe this type of arrangement works for tax purposes. The biggest risk of such a plan is that the IRS will see through the nominal rights the practice has in the annuity/policy and treat the transfer as taxable income to the doctor in year 1 (under section 83, its regulations, and constructive receipt principles). If a physician finally pays tax on retirement in year 20 and the IRS takes this position, that doctor could be liable for taxes, interest, and even penalties going back 20 years!

In addition to the tax problems inherent in such plans, it also is likely that these plans do not work for asset protection purposes either. This is because the legal documentation supporting the plans will likely not stand up to a creditor challenge. The key issue here: Does the loan document securing the A/R really protect the A/R as primary collateral, or is it focused more on the annuity/policy? In all of the plans we have reviewed, the A/R is not primary collateral and, thus, not adequately protected, which is the primary goal.

Common language to look for in these plans include an investment in an insurance policy that is described as "high early cash value" or "with cash value equal to or greater than 100 percent of the loan." Though not every use of these types of policies signifies an inadequate plan, the existence of such language should urge the physician to have an asset protection attorney review the transaction to determine the adequacy of the asset protection.

A/R Leveraging the Right Way

Essentially, A/R Financing done right works like this:

- **The practice borrows money from a lender who specializes in A/R lending.**
- **Practice assigns each physician (MD) her accounts receivable.**
- **Practice acts as a collection agent for the MD.**
- **MD agrees to pay the practice for its expenses.**
- **Practice and MD invest in "New LLC."**
- **MD assigns A/R to LLC as her capital contribution.**
- **Practice invests loan proceeds into LLC as its capital contribution.**
- **New LLC buys life insurance policy with investment proceeds.**
- **Practice pledges LLC ownership interest as security for loan.**
- **MD pledges LLC ownership interest as security for loan.**
- **Practice pays annual interest to bank; interest is partially deductible.**
- **LLC releases all excess cash to MD as compensation.**
- **Loan principle is paid by practice**

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from company funds, receivables, or accumulated value in LLC.

- **After loan is paid off, MD receives tax-free income from the insurance policy's cash value to be used for retirement.**
- **Practice is given a return on its investment in the LLC when MD dies. This comes from the death benefit of the life insurance policy and is equal to investment made plus reasonable return as outlined by the IRS.**

This structure satisfies all of the deferred compensation, risk of forfeiture, Section 83, and other issues in which the current financing programs are so deeply mired. Further, when implemented with the right type of security agreement, all the asset protection benefits will also be enjoyed.

These 15 steps may seem very complicated. The truth is, they are. There are dozens of variations on this type of planning and it is impossible to go through all of the necessary steps needed to help you achieve the necessary asset protection benefits, as well as potential tax reduction and retirement enhancement benefits you might like. Nonetheless, heed this warning: Most of the ways doctors have been implementing this strategy are absolutely wrong.

In today's environment, you would be wise to investigate how A/R financing can shield your practice's most valuable asset AND give you more retirement income. Of course, you have to do it right to get these benefits and not a tax bill. ■

A special report on the malpractice crisis, including an in-depth discussion on A/R protection strategies, is available through the UO Web site: *www.uoworks.com.*

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