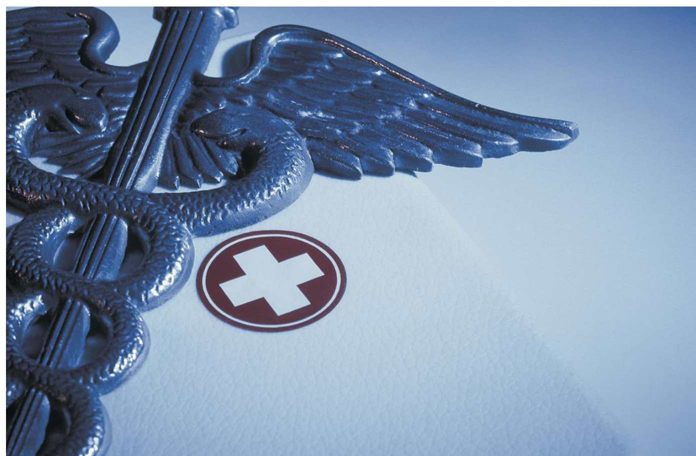

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HEALTHCARE **LEGAL**NEWS

RESTRICTIONS ON FEES PERMITTED UNDER HIPAA FOR COPIES OF MEDICAL RECORDS

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When health care providers provide copies of medical records to an individual patient or to third parties at the direction of that individual patient, they are permitted under HIPAA to recover "a reasonable, cost-based fee." Health care providers have generally determined this fee by relying on a schedule established by state statute, such as the Michigan Medical Records Act (MRA). However, recent guidance issued by the Office for Civil Rights of the U.S. Department of Health and Human Services (OCR) may preempt these state statutes if the state statutes are "contrary to" the guidance (*i.e.*, where it is not possible to comply with both HIPAA and the state statute). Where state statutes merely provide greater rights of access than HIPAA, however, the state statute is not preempted and health care providers must comply with both.

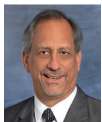
The guidance issued by OCR permits a fee that includes only: (1) labor for copying the records requested by the individual whether in paper or electronic form; (2) supplies for creating the paper copy (*e.g.*, toner and paper) or electronic media (*e.g.*, CD or USB drive) if the individual requests that the electronic copy be provided on portable media; (3) postage, when the individual requests that the copy, or the summary or explanation, be mailed; and (4) preparation of an explanation or summary of the records, if agreed to by the individual. The guidance also describes three methods that health care providers may use to calculate the fee. First, the provider may calculate the actual labor and supply costs incurred to fulfill the request. However, this cost may only include the items outlined above. Second, the provider may develop a schedule of costs for labor based on average labor costs to fulfill standard types of access requests. Again, any such average may only be derived from the costs specifically permitted (so, for example, if time is spent searching and retrieving the information, this time may not be included). Finally, for all electronic requests of PHI maintained electronically, the health care provider may simply charge a flat fee of $6.50 (if paper is involved, however, one of the other two methods must be used).

This guidance arguably preempts fee schedules such as that under the MRA. The MRA established a fee schedule based on the number of pages in the records, ranging from $1.17 a page to $0.23 a page (as well as an initial fee of $23.34 that may not be charged if the patient requests his or her own record). This schedule is not cost-based, nor is it calculated based on actual or average costs of labor and supplies. More importantly, the MRA rates are likely much higher than the actual

or average costs of labor and supplies. However, the MRA also provides that a "medically indigent individual" may not be charged anything for copies of their medical records. This provision is not contrary to anything in HIPAA, merely provides greater rights of access for certain individuals, and is therefore likely not preempted.

What this means for health care providers is that they can no longer rely on state statutes as a "safe harbor" with respect to the medical records fees they charge for information proficed to patients or to others at the direction of the patient. They will need to calculate their actual or average costs of labor and supplies, or outsource medical record production to a third party who has already calculated these costs.

RENEWED PERILS FROM "ZEROING OUT" A CORPORATION AT YEAR-END



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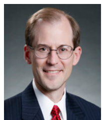

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Physicians who are involved in the financial management of their practices are all too familiar with the year-end scramble to "zero out" the corporation's profits. Under this technique, a physician practice that is structured as a "C" corporation will, after paying all of its year-end expenses, distribute its remaining profits to its shareholders as bonuses. A corporation that effectively uses this technique is left with little or no taxable profits at year-end and thus little or no federal tax liability.

A recent Tax Court case raises renewed concerns about this approach. That case, *Brinks Gilson & Lione PC* (TC Memo 2016-20), involved an intellectual property law firm structured as a professional corporation that was also taxed as a "C" corporation. Like most professional practices structured in that manner, it regularly issued year-end bonuses to its shareholders from its remaining year-end profits, thus minimizing both its year-end taxable income and any resulting federal tax liability. (While some physicians may delight to learn of attorneys facing scrutiny from the IRS and resulting penalties, the analysis of this case potentially applies to any professional corporation that is structured as a "C" corporation that issues its remaining year-end profit as bonuses to its shareholders regardless of the type of services provided.)

That case involved two particularly troubling aspects. As a result of an audit prior to the actual Tax Court case, the law firm ultimately acceded to the determination of the Internal Revenue Services that at least some portion of the year-end bonuses issued by the corporation to its shareholders should have been classified as dividends. A significant concern with this determination of the IRS is the prevalence of the use of the "zeroing out" technique by professional corporations and the tax effect of issuing dividends. Unlike a bonus or other form of compensation, a dividend is not a deductible expense. A corporation that issues dividends is thus usually left with some amount of year-end taxable income. And, unlike individual tax rates, which are graduated, a corporation's federal tax rate is 35%, beginning with the first dollar of taxable income. Accordingly, if the IRS is now signaling that using the "zeroing out" technique to the exclusion of issuing dividends of some amount is disfavored or even impermissible, professional corporations may need to reconsider their approaches and structures or risk incurring tax liability and/or potential tax penalties.

The other problematic aspect of that case was the Tax Court's conclusion that the law firm lacked "substantial authority" in support of its position. In other words, the Tax Court ruled that the law firm did not have a reasonable basis under the tax code for claiming a deduction for the year-end bonuses it issued to its shareholders. The Tax Court rejected the law firm's defense that it acted reasonably and in good faith by relying on its accountants. As a result, the law firm had to pay penalties in addition to potential taxes resulting from the dividends it agreed to pay as a result of its audit.

This is not the first time the Tax Court has issued a ruling like this. In 2001, in *Pediatric Surgical Associates, PC. v. Commissioner* (TC Memo 2001-81), the Tax Court also ruled that a portion of year-end bonuses paid to that professional corporation's shareholders had to be recharacterized as dividends. That case involved a professional corporation with four shareholder-physicians and two nonshareholder physicians. The Tax Court held that some portion of the profit generated by the nonshareholder physicians and distributed to the shareholders represented a return on the investment of the shareholders in the corporation and thus constituted a (nondeductible) dividend rather than some form of (deductible) compensation.

When the *Pediatric Surgical Associates* case was issued, some suggested that it was merely an aberration that did not necessarily reflect the IRS's general position. The recent *Brinks Gilson* case, which specifically cited the prior *Pediatric Surgical Associates* case, seems to confirm the IRS's prevailing view that a professional corporation should typically pay some "reasonable" amount of dividend to its shareholders and that "zeroing out" a professional corporation at year-end through bonus distributions without any associated dividend may involve at least some degree of tax-related risk. On the other hand, the IRS has not announced, at least publically, that it is making this matter a particular enforcement priority. At least for now, it seems that the IRS will challenge corporations that "zero out" in this manner when the opportunity arises but that it probably is not investigating corporations only for this.

The dilemma for professional corporations that regularly "zero out" at year-end without paying dividends is how to react to this latest ruling. Many professional corporations have done nothing differently since the 2001 *Pediatric Surgical Associates* case and have been fine from a tax standpoint. Again, however, the *Brinks Gilson* case may signal a reason for greater concern.

One option for professional corporations is to pay a "reasonable" dividend of some amount to its shareholders. If the shareholders' paid in capital (i.e., their aggregate shareholder buy-in payments) is

not too large, issuing dividends of between five and ten percent of that invested capital would probably not be large enough to result in either significant taxable income or federal income taxes. Under this approach, the corporation would use some of its year-end profits to pay a dividend and then distribute the rest as shareholder bonuses, just as before. This step alone would probably be sufficient to avoid the sorts of problems identified in the *Brinks Gilson* and *Pediatric Surgical Associates* cases. But this approach might not be financially viable for a corporation with significant shareholder equity or that already has some amount of federal income tax.

At a minimum, a professional corporation should have a specific, articulated shareholder compensation methodology, preferably one that is directly connected to each shareholder through appropriate provisions in each shareholder's employment agreement. With that in place, if the IRS asserts that some portion of the corporation's year-end bonuses to its shareholders should be recharacterized as dividends, the corporation has an argument that it would be in breach of its established contractual compensation obligations if it were required to pay some amount as a dividend that would reduce those payments. For this approach to have a chance of being effective, the compensation methodology would need to provide for a specific formula for allocation of profits, rather than merely stating that any year-end profits will be generally distributed as shareholder bonuses.

Especially in small or mid-sized professional practices, many different shareholders often perform some amount of the administrative services necessary to support the corporation's operations. Another possible approach is to explicitly identify those services and specify that some amount of a shareholder's total compensation is for performing those administrative services. That would involve appointing each shareholder as a particular officer of the corporation, developing at least minimal job descriptions for each of those positions, and formally designating, in either each shareholder's employment agreement or the corporation's compensation methodology, that some amount of a shareholder's total compensation is for performing his or her designated administrative duties. Although probably not likely to be as effective as paying a dividend, this approach would provide a professional corporation with another potential argument against an attempt by the IRS to reclassify a portion of year-end bonuses as dividends.

In response to the *Pediatric Surgical Associates* case, some professional practices made "S" corporation elections or even converted into professional limited liability companies. While those approaches effectively eliminate the potential dividend issue identified in this article, they have other potential consequences. For example, converting a corporation into a professional limited liability company can result in one-time, immediate taxable consequences. In addition, the eligibility and tax treatment of certain employee benefits (such as health insurance and medical expense reimbursement plans) are handled differently for shareholders of a corporation that makes an "S" corporation election as compared to these tax consequences for the owners of a professional limited liability company, which may not be appealing to those shareholders or owners.

In light of this recent tax case regarding these matters, professional corporations that have historically "zeroed out" profits at the end of each year may want to take this opportunity to discuss this issue with their professional advisors and undertake some additional planning before another year-end approaches.

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