Ralph Levy, Jr.

Beware of the Tax Consequences of Physician Recruitment Payments

Prospective Employers Should Review the *Vancouver Clinic* Case before Structuring Incentive Payments to Newly Recruited Physicians

A recent federal district court decision points out the risks of adverse federal income tax consequences in a physician recruitment arrangement that use the "loan and forgiveness model" under which shortly after hire, as an inducement to a newly recruited physician, an employer (typically an employing hospital or physical practice group) will make one or more payments to a newly employed physician. If the physician complies with all obligations under his or her employment agreement by performing services for an agreed upon time period, the obligation of the physician to repay the "loan" (with any interest) is forgiven.

In *Vancouver Clinic, Inc. v. United States*, (W.D. Washington, April 9, 2013), the District Judge found that advances made by the taxpayer (Vancouver Clinic, a multi-practice group in the southwest area of the state of Washington, the "clinic") to newly recruited physicians should have been treated as compensation in the year paid. As a result, the court upheld the assessment by the Internal Revenue Service of income tax withholdings, FICA taxes, and interest against the clinic; found that the taxpayer should have withheld income taxes against the advances as they were made to the newly employed physicians; and concluded that the clinic also should have paid its employer share of employment taxes (FICA) thereon.

The clinic entered into an "Associate Physician Loan Agreement" with each newly hired physician that required the physician to work for the taxpayer for a period of five years. The opinion did not indicate whether the practice group also signed a separate promissory note or an employment agreement with each physician. The

Ralph Levy, Jr. is of counsel in the Nashville, Tenn. office of Dickinson Wright PLLC. He can be reached at 615/620-1733 or by email at rlevy@dickinsonwright.com. Dickinson Wright PLLC is a full-service law firm with over 350 attorneys with offices in Michigan, Tennessee, Arizona, Nevada, Ohio, Washington, D.C., and Toronto, Ontario.

Wolters Kluwer Law & Business

clinic typically advanced anywhere from $24,000 to $30,000 to each newly recruited physician during the first two years of employment. The exact amount paid varied based on the physician's specialty and the difficulty in recruiting the physician.

The clinic did not treat the loans as compensation until the fifth anniversary of the physician's employment at which time the clinic forgave the advances and issued a Form 1099 to each physician whose "loans" were forgiven. The physician was not required to repay the clinic the amounts advanced or interest thereon at the rate specified in the Associate Physician Loan Agreement unless the physician violated the five-year service requirement.

In reaching its decision, the district judge looked to the intent of the parties – that each physician perform services for the clinic during the entire five years called for under the employment agreement at which time the loan would be forgiven. The parties did not anticipate that the loan would be repaid or that interest would be paid to the clinic. The court indicated that its analysis was supported by the fact that despite the legal requirement in the Associate Loan Agreements that each physician repay the clinic the full amount of the advances with interest if the physician failed to serve the entire five-year period, the terms of each agreement were not dispositive or even persuasive of the real issue posed: whether the parties intended that the funds advanced ever be repaid to the employer. Such an intent was required in order for the court to determine that the loans were *bona fide* and not disguised compensation. Moreover, the court found that during the three-year audit period in which considerable funds were advanced by the clinic to many newly hired physicians, all recipients of these advances met the period of service requirements and did not have to repay the loaned amounts.

As authority for its decision, the district court did not refer to an unpublished 1998 private letter ruling to the effect that physician recruitment payments by a tax-exempt hospital to physician groups or individual physicians using the loan and forgiveness model did not affect the tax-exempt status of the hospital provided that the amount of each forgiven loan was consistent with the federal anti-kickback statute. Perhaps the court did not refer to this ruling since it did not specifically address the income tax consequences of the loan and forgiveness model to the recruited physician.

In addition, the court did not cite a 2002 Tax Court memorandum decision (*Antonio Rosario v. Comm'r*, TC Memo 2002-70 (2002)) in which the Tax Court found that "income guarantee" payments received by the taxpayer-physician were found to be true loans and not disguised compensation. In that case, the agreement that established the payment obligation did not originally specify the repayment provisions and the taxpayer-physician did not execute a promissory note until well after the start of the physician's employment at which time the agreement was amended to specify the repayment provisions. However, because the physician's obligation to repay the amounts received was secured by the physician's accounts receivable and action was taken by the employer to enforce the repayment obligation under the note, the taxpayer-physician successfully proved that the payments were in fact loans.

Although the *Vancouver Clinic* case may be considered an aberration, several lessons can be learned in structuring advances to newly recruited physicians using the loan and forgiveness model:

1. Lesson No. 1: Use a separate employment agreement to specify the physician's compensation and other employment terms. The length of the initial term of the employment agreement should match the "service requirement." In this manner, the arrangement as to physician compensation can arguably "stand on its own."
2. Lesson No. 2: The newly recruited physician should execute a promissory note that requires periodic payment of a por-

Wolters Kluwer Law & Business

tion of the principal and all interest on the loaned amount over the course of the physician's employment. Under present guidelines, the minimum interest rate for such a promissory note to avoid imputed interest for federal tax purposes is still quite low as compared to historical rates. In the 2002 Tax Court case that found that income guarantee payments to a physician were intended to be loans, the taxpayer-physician had executed a promissory note to evidence the debt to the employer.

3. Lesson No. 3: Structure the physician's compensation to take into account the requirement that the physician repay the loan amount to the lender in full with interest once the physician meets the service agreement that is imposed by the employment agreement. This means that at a minimum the promissory note (see Lesson No. 2) should call for the physician to make a balloon payment of any previously unpaid principal at the end of the initial term of the employment agreement. However, the employment agreement could call for a bonus payment by the employer to the employed physician equal to the "repaid" loan amount after the expiration date of the initial term of the employment agreement. Depending on the bargaining power of the newly hired physician, this payment by the employer could be "grossed up" to repay the physician for the income tax cost of receipt as a bonus payment of the funds with which to repay to the employer the loaned amounts with interest.

If the recruitment arrangement is restructured in this manner, the "loan and forgiveness" model is a misnomer. The revised model should best be called the "loan, employment agreement and bonus model."

Advisors to hospitals or practice groups that wish to make advances to newly hired physicians as part of a recruitment incentive package should review the *Vancouver Clinic* case before structuring these incentive payments. The refinements suggested above should reduce the risks of adverse tax consequences of the traditional "loan and forgiveness" model for these payments to avoid the unanticipated taxes incurred by the clinic in the *Vancouver Clinic* case.

Wolters Kluwer Law & Business

Reprinted from Journal of Health Care Compliance, Volume 15, Number 5, September-October 2013, pages 47-49, with permission from CCH and Aspen Publishers, Wolters Kluwer businesses.
For permission to reprint, e-mail permissions@cch.com.