The Virginia Health Lawyer

Bringing Healthcare and Law Together

Table of Contents

Letter from the Chairman 1

Confidentiality of Department of Health Professions Information: Is it all it is cracked up to be? 2

IRS Issues Final Intermediate Sanctions Rules 4

Pediatric Surgical Associates, P.C. v. Commissioner: A Phoenix Rising from the Ashes? 8

Welcome to a new look and a new edition of The Virginia Health Lawyer (previously Health Law News)!

Letter from the Chair

James M. Daniel, Jr.
Crews & Hancock, P.L.C.

As the 2001-2002 State Bar year comes to a close, we have some exciting news to announce about the Health Law Section. First, I am pleased to introduce our new officers and Board members for 2002-2003. Tom Brown will be serving as Chair for the 2002-2003 fiscal year. Walt Sowers will be our Vice Chair, and John Bilzor will be serving as Secretary. In addition, John Bilzor, Marie Graham, and Steve McCoy have been elected to four-year terms on the Board of Governors.

We also have some exciting news about the Newsletter. Over the next year we will be introducing a new format to the Newsletter. The Newsletter will continue to include articles from attorneys about significant legal developments. However, future issues will hopefully include interviews with federal and state officials, articles from non-attorneys, and other information that will be useful to the section. In keeping with these changes, we have renamed the Newsletter "The Virginia Health Lawyer."

Finally, we have started a new list serve for members of the Health Law Section. The list serve will help to facilitate discussion among members and to provide useful information about important health law issues. To be added to the list, a user simply sends a message to with the word "subscribe" in the text. To make submissions to the list serve, the user simply e-mails their question/comment to the following address: healthlaw@vipnet.org.

As my tenure draws to a close, I want to thank the Health Law Section and the Board of Governors for the opportunity to serve as Section Chair. I have appreciated the opportunity to meet with attorneys across the state and to work on issues that are important to you. I am also proud to report that we have accomplished a lot over the past year, including the joint CLE program with the VBA and important changes to the Section bylaws. Thank you again for this opportunity, and congratulations the new officers and Board members as they begin to lead the Section for 2002-2003.

Confidentiality of Department of Health Professions Information: Is it all it is cracked up to be?

by: Jeannie A. Adams, Esquire
Crews & Hancock, P.L.C.

After appearing with your client before a special conference committee of the Virginia Board of Medicine (the "Board"), the Board determines that there is insufficient evidence to substantiate the charges contained in its notice of informal conference (the "Notice") and dismisses its case against your client. Alternatively, the Board simply closes the case imposing no sanction. Obviously, you and your client are thrilled with this result. However, your client may not be so happy when a copy of the Board's Notice – including every detail that was found by the Board to be unsubstantiated – appears on the Internet. In 1998, the Virginia General Assembly passed legislation requiring that physicians and podiatrists licensed by the Virginia Board of Medicine ("Board") "make available" certain information. Besides the more innocuous information such as Board certification, education, and years in practice, the legislation requires the Board to make available "a final order of the Board relating to disciplinary action." (emphasis added) Va. Code §54.1-2910.1 (10). In addition, other information related to competency "as specified in the regulations of the Board" must be made available. See Va. Code §54.1-2910.1(11)

"your client may not be so happy when a copy of the Board's Notice – including every detail that was found by the Board to be unsubstantiated – appears on the Internet."

Regulations made final on January 31, 2001 implement the statutory requirement that the Board make this information available to the public. Specifically, 18 VAC 85-20-290(B) directs that the Board "shall make available as part of the profile, information regarding disciplinary notices and orders as provided in §54.1-2400.2(D) of the Code of Virginia." Va. Code §54.1-2400.2(D) regarding confidentiality of information obtained during an investigation or disciplinary proceeding, requires that "orders and notices of a Board relating to disciplinary action shall be disclosed." Information submitted by physicians to the Board pursuant to Va. Code §54.1-2910.1 and regulations implementing the practitioner profile system (the "Profile System") is made available to the public through the Internet, at www.vahealthprovider.com.

In July 2001, an amendment to Va. Code §54.1-2910.1 was rushed through the Virginia General Assembly, presumably on the premise that the amendment would prevent the Board from posting information on the Profile System regarding unsubstantiated charges filed against physicians. Backers of the Bill cited a concern with the Board publishing allegations when a physician had been found innocent of a claim.[1] Senate Bill 10, approved on July 19, 2001, directed the Board to specifically make available "final orders of the Board… that result in the denial, probation, revocation, suspension or restriction of any license or that result in the reprimand or censure of any licensee". Further, Senate Bill 10 contained a curious directive that "complaints of misconduct that have not resulted in any disciplinary action or proceeding shall only be made available upon request from a consumer identifying the specific physician or podiatrist for whom the information is requested or as provided in §54.1-2400.3." The original language from Va. Code §54.1-2910.1(11) incorporating "other information… as specified in regulations," into the Profile System, remained. On July 24, 2001 www.vahealthprovider.com went live to the public, and according to information published by the Board, has averaged a significant number of visits per day.

Unfortunately, Senate Bill 10 did not accomplish its intended result, which appeared to be that if charges against a physician were found by the Board to be unsubstantiated, nothing would be posted on the Profile System. Instead, even when the Board finds that there has been no violation of its laws, rules and regulations, dismisses its case against a physician, or closes the case imposing no sanction, the Board's Notice, a document which sometimes contains inflammatory and ultimately untrue information, along with the final order of the Board dismissing the action, appears on the Internet, available at the touch of a button.[2] Further, Senate Bill 10 actually

expanded the scope of information available to the public when it directed that the Board make complaints of misconduct available upon request from a consumer identifying the specific physician or podiatrist for whom the information is requested. Prior to July 19, 2001, complaints were never public information, and have until recently, been only subjectively released to the subject of the complaint.

Perhaps recognizing this unintended result, Senate Bill 59 passed by the 2002 General Assembly, effective February 28, 2002, eliminates all of the language added by Senate Bill 10.[3]
However, Va. Code §54.1-2910.1(11) remains, now codified as Va. Code §54.1-2910.1(A)(12), directing that "other information relating to the competency of doctors of medicine, osteopathy and podiatry as specified in the regulations of the Board", be maintained as part of www.vahealthprovider.com. 18 VAC 85-20-290(B) also remains, directing that information regarding disciplinary notices and orders as provided in Va. Code §54.1-2400.2(D), be made a part of the Profile System. The Board takes the position that a Notice, even if ultimately unfounded, relates to disciplinary action – the disciplinary action being the calling of an informal fact finding conference. See Va. Code §54.1-2400.2(D). According to Board representatives, Senate Bill 59 will apparently not change this practice, although the Board may attempt to modify the manner in which notices and orders are displayed.[4]

Notices issued as to charges that are ultimately dismissed or closed, and in which no disciplinary action or sanction is imposed, should not be made a part of the Profile System. The public is not well served by the display of a notice and final order where the Board has dismissed all charges against a physician or finds no evidence of a violation. Publication of such information actually harms the physician who is the subject of such a scenario, because Notices often contain allegations that are unsupported by the record and can, if viewed by those unfamiliar with the process, taint the public's opinion of a good physician who has been the subject of an unfounded complaint. Senate Bill 59 directs the Board to promulgate regulations implementing its provisions within 280 days, including a "provision for the display of final disciplinary orders of the Board together with notices thereof…". Va. Code §54.1-2910.1(C)(2). Because arguably, no "disciplinary order" is issued where the charges against a physician are dismissed, the corresponding Notice should not be made a part of the Profile System. Board regulations should be promulgated by December 2002 and in the process, the Board will hopefully clarify this issue to the benefit of physicians who have appeared before the Board, and successfully fought to clear the allegations contained in a Notice.

"The Board takes the position that a Notice, even if ultimately unfounded, relates to disciplinary action – the disciplinary action being the calling of an informal fact-finding conference."

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[1] Tammie Smith, "Web site about doctors scrutinized", Richmond-Times Dispatch, July 11, 2001, at B3.

[2] While disciplinary notices and orders have always been available to the public upon request, Internet publication obviously reaches a much broader audience.

[3] Senate Bill 59 also made several other clarifying amendments to the Profile System, unrelated to the specific content of this article.

[4] The Board also reports notices and orders in which no disciplinary action is imposed (but where a violation is found), to the Healthcare Integrity and Protection Data Bank ("HIPDB")pursuant to 45 CFR Part 61, which requires the reporting by state medical boards, of certain final adverse actions against health care providers. The HIPDB regulations include as final adverse actions, "any [other] negative action or finding by [a] federal or state [licensing] agency that is publicly available information." 45 CFR §61.7. "Any other negative action or finding" is defined as "any action or finding that under the State's law is publicly available information, and rendered by a licensing or certification authority …" 45 CFR §61.3. In Virginia, the Board makes even notices and orders in which no disciplinary action is ultimately taken against a licensee, and even where no violation is found, publicly available. However, where the charges contained in a notice are dismissed or no violation is found, the Board apparently does not report to the HIPDB. Furthermore, no report is made by the Board to the National Practitioner Data Bank if no sanction is imposed. (i.e., revocation, restriction, suspension, censure, reprimand or probation). 42 U.S.C. §11132(a).

IRS ISSUES FINAL INTERMEDIATE SANCTIONS RULES

by Clifford A. Coppola, Esquire
Williams Mullen

INTRODUCTION

On January 23, 2002, the Internal Revenue Service published final regulations in the Federal Register regarding excise taxes on excess benefit transactions under Internal Revenue Code ("Code") § 4958[1]. This Code section imposes a tax on "disqualified persons" engaged in "excess benefit transactions" with tax-exempt organizations. The tax is applied in two "tiers." First, § 4958(a)(1) imposes a first tier tax in the amount of 25% of the excess benefit. Second, if the transaction is not "corrected" within the taxable period, a second tier tax of 200% of the excess benefit is imposed under § 4958(b).

In addition, § 4958(a)(2) imposes a tax of 10% of the excess benefit, up to a maximum of $10,000 for each transaction, on any "organization manager" who knows that it is an improper transaction, unless his or her participation is not willful and is due to reasonable cause.

The final regulations do not differ significantly from the temporary regulations which were released on January 10, 2001.[2] However, some clarifications and minor modifications have been made. This article highlights some of the key provisions of the final regulations of interest to tax-exempt healthcare entities.

FINAL REGULATION § 53.4958-1 TAXES ON EXCESS BENEFIT TRANSACTIONS

In addition to the general provisions regarding the implementation of excise taxes under § 4958, which have all been retained unchanged from the temporary regulations, the final regulation modifies the temporary regulation with regard to the provisions regarding the tax paid by "organization managers." An organization manager is defined as any officer, director or trustee, or any individual having powers or responsibilities similar to such persons. A person is an officer if specifically designated in the organization's constitutive documents or the individual regularly exercises administrative or policy decisions on behalf of the organization. The final regulation provides a safe harbor for attorneys, accountants, investment managers and advisors who provide professional advice. These persons, who act solely in their professional capacity, are not deemed officers of the organization. Individuals who are not yet officers, directors, or trustees, yet serve on a committee of the governing body of the organization that is attempting to invoke the rebuttable presumption of reasonableness described in regulation § 53.4958-6, are deemed to be organization managers.

> "In addition to the general provisions regarding the implementation of excise taxes under § 4958, which have all been retained unchanged from the temporary regulations, the final regulation modifies the temporary regulation with regard to the provisions regarding the tax paid by 'organization managers.' "

The final regulation provides that an organization manager "knows" of an excess benefit transaction if the individual: has actual knowledge of sufficient facts that such transaction would be an excess benefit transaction; is aware that such a transaction may violate Federal tax law; and negligently fails to ascertain whether the transaction is an excess benefit transaction. The final regulation requires actual knowledge and states that "knowing" does not mean having reason to know. However, evidence showing that a manager had reason to know of a particular fact or particular rule is relevant in determining actual knowledge. Furthermore, an organization manager's participation in a transaction is ordinarily not considered knowing if the individual relied on a reasoned written opinion of a professional. The final regulation also provides that an organization manager's participation is not considered knowing, even though the transaction is subsequently held to be an excess benefit transaction, if the appropriate authorized body of the organization has met and satisfied the rebuttable presumption requirements of regulation § 53.4958-6.

FINAL REGULATION § 53.4958-3 DEFINITION OF DISQUALIFIED PERSON

Code § 4958(f)(1) defines "disqualified person" as any person who is in a position to exercise any substantial influence over the affairs of the organization at any time during the five-year period ending on the date of the transaction in question. In addition, the definition also includes certain family members of such individuals and thirty-five percent controlled entities. The final regulation describes various categories of persons who are deemed "disqualified persons" under this section of the Code.

Individuals serving on the governing body of the tax exempt organization who are entitled to vote, presidents, chief executive officers, chief operating officers, treasurers, chief financial officers and persons with a material financial

interest in a provider sponsored organization[3] are all disqualified persons. Individuals who have or share the ultimate responsibilities of the above named persons are also disqualified persons regardless of their title.

The spouses, siblings, spouses of siblings, ancestors, children, grandchildren, great grandchildren and spouses of children, grandchildren and great grandchildren of disqualified persons are also deemed disqualified. Thirty-five percent controlled entities are corporations, partnerships, trusts or estates in which disqualified persons own more than thirty-five percent of the combined voting power, interest in profits or beneficial interests.

". . .entities, in addition to individuals, can have substantial influence over the affairs of a tax-exempt organization."

The final regulation also identifies persons who are deemed not disqualified persons. These persons include: other 501(c)(3) organizations; certain 501(c)(4) organizations only with respect to other 501(c)(4) organizations; and employees of the tax exempt organization who receive economic benefits from the organization, directly or indirectly, of less than the amount of compensation referenced for a highly compensated employee in Code § 414(q)(1)(B)(i) (currently $80,000) who are not otherwise disqualified persons and are not substantial contributors to the organization.

In all other cases, the final regulation provides that the person's status depends upon all relevant facts and circumstances. Facts and circumstances tending to show that a person has substantial influence over the affairs of the organization include: the fact that the person founded the organization; the fact that the person is a substantial contributor; the fact that the person's compensation is based on revenues derived from activities of the organization that the person controls; the fact that the person has authority to control or determine a substantial portion of the organization's capital expenditures, operating budget or compensation for employees; the fact that the person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income or expenses of the organization; the fact that the person owns a controlling interest in a corporation, partnership or trust that is a disqualified person; and the fact that the person is a non-stock organization controlled directly or indirectly by one or more disqualified persons.

Facts and circumstances tending to show that a person does not have substantial influence include: the fact that the person has taken a bona fide vow of poverty as an employee, agent, or on behalf of a religious organization; the fact that the person is an independent contractor, such as an attorney, accountant, or investment manager advisor, acting solely in that capacity without decision-making authority, unless the person is acting in that capacity with respect to a transaction from which the person might economically benefit, either directly or indirectly (aside from fees received for the professional services rendered); the fact that the person's direct supervisor is not a disqualified person; the fact that the person does not participate in the management of the organization as a whole or discrete segment which represents a substantial portion of the organization; and the fact that any preferential treatment the person receives based on the size of that person's donation is also offered to any other donor making a comparable contribution as part of a solicitation intended to attract a substantial number of contributors.

In the case of multiple organizations affiliated by common control or governing documents, the determination of whether a person is a disqualified person must be made separately as to each applicable tax exempt organization.

The temporary regulation also contained a number of examples which illustrated its application. The final regulation modified one example of particular interest to healthcare providers.

Example 7 indicated that a hospital management company was a disqualified person with respect to a 501(c)(3) exempt organization with membership interests in a limited liability company which owned a hospital. The example was silent as to the management company's actual duties which resulted in its status as a disqualified person. The final regulation clarified this example by stating that the management company was ultimately responsible for supervising the management of the hospital. Accordingly, the management company was a disqualified person per se. The example also clearly shows that entities, in addition to individuals, can have substantial influence over the affairs of a tax-exempt organization.

FINAL REGULATION § 53.4958-4 DEFINITION OF EXCESS BENEFIT TRANSACTION

Code § 4958(c) defines "excess benefit transaction" as any transaction in which a tax exempt organization provides an economic benefit, directly or indirectly, to a disqualified person where the value of the economic benefit exceeds the value of the consideration (including the value of services) provided by the disqualified person. The final regulation adds that a benefit may be provided indirectly through the use of one or more entities controlled by or affiliated with the tax-exempt organization. For example, if an exempt organization causes its taxable subsidiary to pay excessive compensation to a disqualified person of the parent organization, the payment is an excess benefit transaction.

The final regulation retains the "initial contract" exception of the temporary regulation which provides that a fixed payment to a person who is not yet employed by an organization and not yet in a position to exercise substantial

influence is not subject to Code § 4958. In order to qualify for this exception, the initial contract must be a "binding written contract," however, the preamble to the final regulations recognizes that the term is governed by state law and that an exchange of writings short of a formal contract may satisfy the requirement.

The final regulation specifically disregards certain economic benefits for purposes of Code § 4958: fringe benefits excluded under Code § 132; expense reimbursement payments pursuant to accountable plans; economic benefits provided to a disqualified person solely as a member of, or a volunteer for, the tax exempt organization if the benefit is also provided to members of the public in exchange for a membership fee of $75.00 or less per year; economic benefits provided to members of, or donors to, the organization if the membership fees or contributions are deductible under Code § 170 (regardless of whether the member/donor can claim the deduction), the benefits are provided to non-disqualified persons paying membership fees and/or contributions above a specified amount, and the disqualified person and a significant number of non-disqualified persons make payments and/or contributions of at least the specified amount; economic benefits provided to a disqualified person solely as a member of a charitable class served by the tax exempt organization; and transfers of economic benefits to the governmental units defined in Code § 170(c)(1) if made for public purposes.

"Compensation paid to a disqualified person may not exceed what is reasonable under all of the circumstances. . . . Generally, the circumstances to be taken into consideration in determining the reasonableness of a fixed payment are those existing at the date when the contract was made."

The final regulation defines the "excess benefit" subject to the tax as the economic benefit to the disqualified person which exceeds the value of the consideration provided. "Fair market value of property" is defined as the price at which property or the right to use property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy, sell or transfer the property or the right to its use, and both having reasonable knowledge of relevant facts.

The final regulation also defines "reasonable compensation." Compensation paid to a disqualified person may not exceed what is reasonable under all of the circumstances. Compensation for the performance of services is reasonable if it is an amount that would ordinarily be paid for like services by like enterprises, whether taxable or tax-exempt, under like circumstances.

Generally, the circumstances to be taken into consideration in determining the reasonableness of a fixed payment are those existing at the date when the contract was made. However, where the reasonableness of compensation cannot be determined at the time of the contract because of bonuses or other future compensation, the circumstances existing up to the date of the payment may be considered. Any contract that is terminable or subject to cancellation by the tax-exempt organization without the disqualified person's consent is treated as a new contract as of the effective date of such termination or cancellation. Furthermore, any material modification is treated as a new contract entered into as of the date of the modification.

The final regulation provides that items included in determining the value of compensation include all forms of cash and noncash compensation, including salaries, fees, bonuses, severance payments, deferred compensation attributed to the years in which the services were performed, premiums for liability or any other insurance coverage, and all other benefits, whether or not included in gross income for income tax purposes, including medical, dental and life insurance, severance pay and disability plans. Any economic benefit provided by the tax-exempt organization, whether provided directly or through another entity owned or controlled by the tax-exempt organization or through an intermediary, whether such other entity is taxable or tax-exempt, is included.

An economic benefit will be treated as compensation for services only if the organization clearly indicates that it intended to do so when the benefit was paid via contemporaneous written substantiation. Examples include: reporting documents such as original Federal tax information returns with respect to the payment (e.g., Forms W-2 or 1099) or with respect to the organization (e.g., Form 990); amended Federal tax information returns filed prior to an IRS examination; or the report of the benefit as income on the disqualified person's Form 1040 filed prior to any IRS examination. Other examples include: written employment contracts executed on or before the date of the transaction; documentation from the authorized body satisfying Regulation § 53.4958-6 (described below); and written evidence in existence on or before the due date of the applicable Federal tax return. If an organization fails to provide contemporaneous written substantiation, any services provided by the disqualified person will not be treated as provided in consideration for the economic benefit.

FINAL REGULATION § 53.4958-5 REVENUE SHARING TRANSACTIONS

Code § 4958(c)(2) provides that, to the extent provided in regulations, an excess benefit transaction includes any transaction in which the economic benefit provided to or for the use of the disqualified person is determined in whole or in part by the revenues of one or more of the activities of

the organization, if such transaction results in private inurement. The proposed regulation provided general guidance on this issue, but was withdrawn in the temporary regulations, which reserved this section. The final regulation also reserves this section. The preamble states that until specific rules are issued, all transactions, including revenue sharing transactions will be evaluated under the general rules of regulation § 53.4958-4. The preamble also notes that any future regulations on this issue will first be issued in proposed form to allow for public comment.

FINAL REGULATION § 53.4958-6 REBUTTABLE PRESUMPTION

The Committee Report to Code § 4958 provides that the parties to a transaction are entitled to a rebuttable presumption of reasonableness with respect to a compensation arrangement if: the arrangement is approved by the organization's governing body or committee thereof composed entirely of individuals who do not have a conflict of interest with respect to the arrangement; the governing body or committee obtained and relied upon appropriate data as to comparability; and the governing body or committee adequately documented the basis for its determination concurrently with making that determination[4]. The final regulation restates these requirements and adds that the governing body may authorize other parties to act on its behalf to the extent permitted under state law. These parties are defined as "authorized bodies." The preamble notes that a single individual may constitute an authorized body if state law allows.

The final regulation also describes a number of additional requirements in implementing these general standards. The authorized body described above may be comprised of non-board members as permitted under state law. An individual is not deemed to be a member of the authorized body if that person meets with the other members to answer questions and otherwise excuses himself from the meeting and is not present during debate and voting on the arrangement.

Under the final regulation, relevant appropriate data as to comparability includes, but is not limited to: compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the tax-exempt organization; independent compensation surveys compiled by independent firms; actual offers from similar institutions competing for the services of the disqualified person; an independent appraisal of the value of the property that the organization intends to purchase from, or sell to, the disqualified person; and any offers received as part of an open and competitive bidding process.

For a decision to be documented adequately, the final regulation requires that the written or electronic records of the authorized body or committee must note: the terms of the transaction and the date it was approved; the members of the authorized body who were present during debate and those who voted on it; the comparability data obtained and relied upon together with how the data was obtained; and the actions taken by anyone who was a member of the authorized body but had a conflict of interest. The documentation must be made concurrently with the decision, no later than the next meeting of the authorized body sixty (60 days after the final decision. These records must be reviewed and approved by the authorized body within a reasonable time period thereafter.

FINAL REGULATION § 53.4958-7 CORRECTION

The final regulation provides that an excess benefit transaction may be corrected by undoing the excess benefit to the extent possible. The purpose is to place the organization involved in the excess benefit transaction in a financial position not worse than that in which it would be if dealing with a person under the highest fiduciary standards. The amount of the correction equals the sum of the excess benefit plus interest. The correction may take the form of cash or cash equivalents or the return of specific property. If the specific property or other payment is not equal to the correction amount, the disqualified person must make an additional cash payment to the organization equal to the difference.

The final regulation provides additional guidance concerning the situation where the exempt organization no longer exists or is no longer tax exempt. The organization receiving the correction amount must be a publicly supported charity that has been in existence for a period of at least sixty (60) months prior to the date of the correction. Furthermore, the disqualified person may not be a disqualified person with respect to the organization receiving the correction amount and the disqualified person may not make or recommend any grants or distributions by the organization. The preamble states that these requirements prevent the disqualified person from creating a new organization to receive the correction amount.

CONCLUSION

The final regulations go a long way in providing useful procedures and guidelines that tax-exempt organizations can utilize in making decisions concerning business transactions. Practitioners should look for additional regulations, especially in the revenue-sharing transactions area, to be proposed in the future.

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[1] 67 Fed. Reg. 3076 (Jan. 23, 2002).

[2] 66 Fed. Reg. 2144 (Jan. 10, 2001).

[3] A provider sponsored organization is a managed care entity which contracts with Medicare under its Medicare + Choice Program. See 42 U.S.C. §§ 1395 w-23, 1395 w-25.

[4] H.Rep. No. 506 at 56-57.

Pediatric Surgical Associates, P.C. v. Commissioner[1]
A Phoenix Rising from the Ashes?

If So, It Should Be Shot Before It Gets Off The Ground!

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I. Introduction

Unreasonable compensation cases involving professional corporations seemingly had all but disappeared until a recent Tax Court Memorandum decision. Although it is too early to establish whether this case signals a renewed interest by the Internal Revenue Service (IRS) in professional corporations, the ruling provides insight on how the IRS analyzes the way professional corporations, particularly physician practices, pay their shareholder-employees. Typically, professional corporations pay shareholder-employees a salary, with bonuses from time to time of amounts remaining after the payment of all other realized or anticipated expenses. These payments are generally intended to be ordinary and necessary business expenses, i.e., compensation to be deducted by the corporation on its tax returns, thereby avoiding the imposition of the highest corporate tax rates levied against personal services corporations.[2]

II. *Pediatric Surgical* Decision

The Tax Court's April 2, 2001 decision in *Pediatric Surgical Associates, P.C. v. Commissioner* indicates that professional corporations employing both shareholder and non-shareholder employees may have to consider a portion of these bonus payments as non-deductible dividends to the shareholder-employees. Unlike previous Tax Court decisions, this Court's decision focused on the profits earned by a corporation resulting from duties performed by non-shareholder employees. The Tax Court found that such profits should neither be allocated to shareholder employees in the form of bonuses nor classified as deductible officer's compensation on the corporation's corporate return. Instead, the Tax Court found that the profits were in fact a distribution of earnings and profits, and, therefore, nondeductible dividends.

> ". . .th[e] Court's decision focused on the profits earned by a corporation resulting from duties performed by non-shareholder employees."

Pediatric Surgical involved a physician practice that was audited by the IRS for years 1994 and 1995. During that two year period, the corporation employed four shareholder surgeons (one retired in 1995) and two non-shareholder surgeons. The shareholder surgeons received a fixed monthly salary plus monthly bonuses consisting of available cash less amounts necessary for the corporation's short-term expenses. The non-shareholder surgeons received only a fixed monthly salary. The corporation deducted the amounts paid to the shareholder surgeons as "compensation of officers."

The IRS initially issued a notice of deficiency for $598,710 of the $1,300,231 paid shareholders for calendar year 1994. The notice of deficiency for calendar year 1995 disallowed $805,469 of the $1,528,125 paid shareholders. The IRS also assessed a 20 percent accuracy-related penalty in both years pursuant to Internal Revenue Code (IRC) Section 6662(a). The IRS later, on brief, conceded the deductibility of all but $140,766 for 1994 and $19,450 for 1995, and the Court further reduced the assessment to $61,234 and $9,037, respectively. The average shareholder salary was $325,058 in 1994 and $382,031 in 1995. The shareholder surgeons' base compensation was $16,500 monthly while the non-shareholder surgeons' base salary was fixed by a two-year employment contract at $12,000 or $12,500 per month, without bonuses. Finally, the corporation never declared a dividend during the audit years.

The IRS's position in this case was that the corporation was entitled to deduct as wages only the actual collections of each shareholder-employee, less that individual's share of the corporation's expenses. These expenses included such costs considered directly allocated to compensation, such as payroll taxes or individual fringe benefits and those costs considered overhead items.

The corporation disagreed that the compensation deduction

should be based solely on shareholder collections. It stressed in its argument that all of the payments to the shareholders were treated as wages and reported on W-2 statements. The corporation stated the payments made to the shareholders surgeons were clearly compensation for services rendered and not disguised dividends. The corporation also argued strongly that the payments were reasonable because the shareholders received less than their gross collections.

III. Reasonable Compensation - Section 162

The Tax Court's decision focused on its interpretation of IRC Section 162 regarding trade or business expenses. Section 162(a)(1) establishes a two-prong test for the deductibility of payments as salaries or other compensation for personal services actually rendered. To be deductible as compensation for services, the payments must be (1) "reasonable," and (2) "in fact payments purely for services."[3]

The issue presented by the parties' briefs was whether the remaining amounts paid to the shareholder surgeons were compensation purely for their personal services. The Tax Court dispensed with an analysis of the reasonable prong and stated that, to prevail, the corporation had to show that the remaining amounts were paid to the shareholder surgeons purely for their personal services. The difficulty with proving this, the Tax Court stated, was that the shareholder surgeons were not the only service providers employed by the corporation. There were also the non-shareholder surgeons, whose contributions to corporate profit cannot be assumed to be zero.

> " 'Isn't it reasonable that a shareholder-employee with higher seniority andestablished goodwill would have a higher level of compensation?' Based on the reasoning and holding of *Pediatric Surgical,* the Tax Court answer is 'No.' "

IV. Regulation 1.162

The Tax Court's analysis continued with a review of IRC Reg. 1.162-7(b)(1) that states, "Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible."[4] The regulations further provide that an ostensible salary may, if paid by a corporation, be a distribution of a dividend on stock, or may be in part a payment for property. The issue of whether such a payment is a dividend or a payment for property is a factual inquiry, to be decided by the Tax Court based on the particular facts and circumstances of the case. The Tax Court acknowledged that the corporation intended such amounts to constitute payments purely for services rendered. Because the corporation was not necessarily concerned that shareholder surgeon compensation not be overstated, however, the Tax Court reasoned that "where officers-shareholders, who are in control of a corporation, set their own compensation, careful scrutiny is required to determine whether the alleged compensation is in fact a distribution of profits."[5]

Ultimately, the Tax Court accepted the IRS's position, with modifications, that the deductible compensation paid to the shareholders was limited to their individual receipts less their allocable share of corporate expenses. Accordingly, the amount of collections of the non-shareholder surgeons, less an allocation for expenses, was determined to be a non-deductible dividend.

V. Concerns for Professional Corporations

Pediatric Surgical appears to require professional corporations to empirically calculate "reasonable compensation" for their shareholder-employees by using a hard and fast formula. That is, reasonable compensation attributable to services rendered will be calculated in such a manner as to preclude the professional corporation from compensating its shareholder-employees based on the intrinsic, subjective value of that individual. For instance, one would expect to pay a shareholder-employee higher compensation if that individual had a more substantial experience base, reputation or goodwill in that particular business or profession. The *Pediatric Surgical* decision begs the question, "Isn't it reasonable that a shareholder-employee with higher seniority and established goodwill would have a higher level of compensation?" Based on the reasoning and holding of *Pediatric Surgical*, the Tax Court answer is "No."

VI. Conclusion

While this decision is only a Tax Court Memorandum and may be merely an isolated decision, it potentially could negatively impact any professional corporation that employs both shareholder and non-shareholder employees. Applying the *Pediatric Surgical* logic, consider the nightmarish implications to a multispecialty group practice that has many income producing employees who are not owners and significant profit-generating ancillary services. Will the IRS extend the Tax Court's logic to that professional corporation?

We should note that the taxpayer in *Pediatric Surgical* apparently created much of its own problems by failing to keep adequate records supporting the allocation of expenses and documenting the reasons and basis for paying the shareholder-employees bonuses. To avoid *Pediatric Surgical's* fate, counsel should encourage its clients to maintain accurate record-keeping and documentation for all discretionary compensation payments. Taking effective measures, such as proper documentation of the methodology or reasoning behind the bonus decisions, may well deflect the result in *Pediatric Surgical*.

It is premature to determine that the IRS has once again targeted professional corporations for unreasonable compensation challenges. At the very least, this decision is a warning siren for professional corporations to carefully analyze their compensation policies and documentation procedures. Our underlying concern is that the decision appears to arrogate a professional corporation's ability to compensate its shareholder-employees based on the intrinsic value that those employees bring to the business. For now, the IRS has a precedent to use subjective standards to determine reasonable compensation.

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[1] 81 T.C.M. (CCH) 1474 (2001).

[2] A qualified personal service corporation is not allowed to use the graduated tax rates for C corporations. The flat tax rate used by personal service corporations is the highest marginal rate, currently 35%.

[3] I.R.C. § 162 (2001).

[4] Treas. Reg. § 1.162 (2001).

[5] *Pediatric Surgical Assoc.* at *30.