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Physician Recruitment Agreements – Loans Versus Compensation

In an effort to entice and retain talented physicians, many medical groups and hospitals have historically offered loans to new hires. These "loans" are typically structured in connection with some form of income guarantee contract. In many cases, if the physician remains with the practice or hospital for a specified number of years, the debt will be forgiven. The tax treatment of this practice has recently been scrutinized by the IRS.

On April 9, 2013, the Vancouver Clinic, Inc. lost its case against the U.S. because it was determined the funds advanced to recruit and retain its physicians were not loans, but rather compensation. The IRS assessed the clinic for withholding, payroll taxes and interest totaling $626,745. The clinic paid the assessment and filed for a refund. The IRS subsequently disallowed the refund, and the clinic filed suit in U.S. District Court.

The clinic entered into "Associate Physician Loan Agreements" with more than 100 newly hired physicians in 2007, 2008 and 2009. The purpose of the agreements was to assist the clinic in recruiting and retaining new physicians. Under the agreements, each physician was loaned funds during the first two years of employment and, upon the completion of at least five years of employment, the loans were to be forgiven. The loans accrued interest at the prime rate over the five-year term; however, the physicians were not required to pay any interest as it accrued, and there was no fixed repayment schedule at the time the agreement was executed.

As the clinic advanced funds to the physicians, it did not withhold income or payroll taxes and did not report the payments as compensation on a Form W-2; rather, the clinic issued a Form 1099 as the debt was forgiven. The clinic advanced more than $1.5 million during the three-year period and stated that, by the end of 2013, it anticipates more than 80 percent of these loans will have been forgiven.

The court determined that, based on the particular facts and circumstances, neither the clinic nor the physicians intended for the advances to be repaid. Since neither party intended for the funds to be repaid at the time the advances were made, the advances were not loans, but rather current compensation subject to withholding and related payroll taxes. The court determined the reasonable expectation of both parties was that the physicians would remain employed for five years and the advances would be forgiven. According to the court, the agreement essentially functioned like a liquidated damages clause for the physician's breach of promise to remain employed.

What could the clinic have done differently to avoid this outcome?

The clinic could have done several things to structure a bona fide loan agreement, such as providing a specific repayment schedule and evidencing the transaction with a properly executed promissory note. In addition, the clinic could have performed a financial background and credit check on each physician. As opposed to the clinic forgiving the loan amounts, the physician could use future compensation—either regular compensation or bonuses—to make the scheduled interest and principal payments to the clinic. If the physician did not remain employed at the clinic, there could still be an obligation and expectation for repayment under the terms of the promissory note; however, the clinic would need to strictly enforce the repayment.

Another option would have been for the clinic to pay all the funds advanced as compensation, while maintaining an obligation for repayment if the physician did not remain employed for the five years. Under this scenario, the physician would include the amounts as taxable income when received even with the obligation for repayment. Under the "claim of right" doctrine, the physician would include all current payments as income; however, if a physician had to repay amounts at a later time, he or she could be entitled to a deduction under Code Section 1341 if the following conditions are met:

1. The amount repaid was properly included in income because the physician had an unrestricted right to the funds
2. The amount would otherwise be deductible
3. The amount repaid is in excess of $3,000

In general, if the physician qualifies for this deduction due to a repayment, the physician would be permitted to compute his or her taxes for the year of repayment in a manner that gives the physician the equivalent of a refund of the taxes previously paid on the amounts repaid.

The Vancouver Clinic case provides important information for physician groups and hospitals that enter into these types of arrangements on how to properly structure the agreements to avoid any unintended tax implications.

For more information on structuring physician recruitment agreements, contact John Bruce, CPA at jbruce@bkd.com or 210.341.9400