

THE REASONABLE COMPENSATION DEDUCTION UNDER THE NH BUSINESS PROFITS TAX - WHAT PHYSICIAN PRACTICES CAN DO TO REDUCE AUDIT RISK

By: *Jason E. Cole, Esquire, CPA*
jcole@devinemillimet.com
603.695.8566

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Compensation levels of key employees and owners are under attack. For publicly traded corporations, there is a cap on compensation that can be deducted for key employees in the tax code. Congress continues to discuss further limitations on the deductibility of executive compensation at the federal level and have already put in place additional limitations on compensation that can be taken by executives of organizations which received federal assistance through programs like TARP.

The healthcare industry is not immune from such scrutiny. The recently revised non-profit information tax return (the "IRS Form 990") provides for additional reporting of executive compensation and the governance section of the IRS Form 990 suggests that organizations should have formal executive compensation policies in place. Greater scrutiny of executive compensation at the non-profit level as well as the basis for such compensation has high stakes in terms of maintaining the organization's tax exemption and the possibility of paying a hefty excise tax on compensation which is deemed unreasonable.

At the state level, compensation is an issue for physician owned practices. New Hampshire for-profit physician practices are subject to the New Hampshire Business Profits Tax (the "BPT"). The BPT, which is an 8.5% net income tax on business profits allows proprietorships, partnerships, limited liability companies, and professional limited liability companies, to deduct "reasonable compensation" fairly attributable to the personal services of the business owner. Corporations or professional corporations are just as susceptible for a DRA review, even though the language in the statute is specific to partnerships and proprietors. The DRA has been, and continues to aggressively audit the reasonable compensation deduction.

In our experience, physician practices are a likely target for the DRA for a couple of reasons. First, despite the fact that physicians work an

Office Locations:

111 Amherst Street
Manchester, NH 03101
T 603.669.1000
F 603.669.8547

300 Brickstone Square
Andover, MA 01810
T 978.475.9100
F 978.470.0618

43 North Main Street
Concord, NH 03301
T 603.226.1000
F 603.226.1001

DEVINEMILLIMET.COM

HEALTHCARE@DEVINEMILLIMET.COM

incredible amount of hours, provide highly valued services, are active in the administration and management of their practices, and are driven individuals which result in high levels of performance, the sheer amount of compensation to physicians tends to get the DRA's attention. Second, the DRA has latched onto industry averages and used that comparative data as their benchmark for reasonable compensation levels arguing that a physician should simply get the mean or median of industry averages. Generally speaking, this approach has resulted in lower levels of compensation. These positions are flawed because the DRA is not taking into account the individual services and value of each physician-owner or considering individual performance and expertise which requires greater compensation. [Note: This should not be interpreted to mean that industry compensation averages, such as those surveys published by the Medical Group Management Association ("MGMA"), are an unacceptable source for fair market value determinations for Stark and anti-kickback statute purposes.]

The DRA has also been increasingly more interested in what limited liability company operating agreements and partnership agreements provide in terms of compensation to their owners in exchange for services rendered. Employment agreements between physician-owners and the physician practice have attracted attention as well. Anything in excess of amounts spelled out in these types of documents are likely to be deemed by the DRA as unreasonable compensation thereby decreasing the physician practice's deduction and increasing the tax liability.

As physician practices gear up to hold their annual meetings this Spring, we recommend that they contact their legal and financial counsel and proactively rethink the way they compensate themselves. Amending documents to provide for guaranteed payments, salary or incentive based compensation, specifying the services required to be rendered by the individual and documenting the required approvals can go a long way to supporting physician-owners future compensation deductions and may dampen the DRA's enthusiasm to question the reasonableness of a physician practice's compensation deduction. In other words, adopting a compensation methodology at the beginning of a tax year rather than after the fact is more credible of reasonable compensation. For example, consider the following:

(1) Compose a descriptive list of the services that the physician-owners provide to the practice. As you review the list, be sure to detail the efforts that provide the greatest business value. In the case of physician-owners, it will be the medical and top-level managerial, financial and operational activities that warrant the greatest level of compensation.

(2) Document efforts that are difficult to quantify, such as creating and maintaining goodwill, patient loyalty or arrangements with hospitals and other medical care facilities which are unique to the physician practice and which can be attributable to the services and reputations of the physician-owners.

(3) Physician-owners work a lot of hours. By the very nature of being "on-call", some physicians work twenty-four (24) hours a day on

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F 978.470.0618

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T 603.226.1000
F 603.226.1001



certain days of the week. Resist the temptation to segment a workday into hours. The DRA wants to categorize physicians in practice areas, take an average hourly wage based on the median of the industry and multiple the hourly rate by the number of hours worked. The result will never reflect the value of the services provided by the physician-owner, particularly since these individuals almost always perform above average.

(4) Document the qualifications of the physician-owner. When it can be established that the physician-owner in question is highly qualified, a salary higher than could otherwise be justified may be reasonable. Details about formal education, experience, motivation, leadership, stature, imagination and proven medical and business judgment have all been considered indicative of higher compensation.

(5) Perform industry research. Benchmark data that supports the compensation deduction suggests reasonableness. If the physician-owners outperform the averages, explain why and use the benchmark data to prove this point.

(6) Avoid or be able to explain compensation which appears to be ownership driven. It is common for physician practices to pay physician-owners equally. This could be considered a red flag to the IRS or DRA because from their perspective, it suggests that compensation is primarily based on ownership and not for services provided. Even if compensation remains equal among the physician-owners, be prepared to explain why this is the case and how the compensation relates to individual services.

(7) Consider declaring a dividend. An auditor who reviews a generous increase in compensation to a physician-owner from a profitable organization, could take the position that the increase in salary was motivated by a corporate intent to distribute profits in a form that is deductible to the corporation. By declaring a dividend, the physician practice is demonstrating that it is accounting for profits separately from compensation for services.

(8) Review the physician practice governance documents and make sure that they include a provision stating which party is responsible (all of the members/partners, the general partner, the limited partners, the Board of Directors) for establishing the compensation of the owners. The provision should also include the vote requirement for approving the compensation to be paid to a member or partner. Some operating or partnership agreements establish the compensation to be paid directly in the agreements. In addition, the agreement could outline the services expected to be provided by a partner or member in exchange for such compensation. Physician practices should also consider the use of guaranteed payments in exchange for services which may require special provisions in the governing documents as well.

(9) Consider implementing employment agreements with the physician-owners. An employment agreement should address the services required to be rendered as well as the compensation that the physician-owners will receive in exchange for those services. The physician-owner may be compensated through wages, salary, and



incentive based compensation. In addition to monetary compensation, the agreement often specifies a fringe benefit package, including a retirement plan, employee stock options, holiday entitlement, and health insurance benefits. The more specific that an employment agreement can address these topics of compensation and detail the type of level of services that the physician-owner is required to perform, the more reliable the document will be in supporting the reasonableness of the compensation deduction.

If your compensation deduction is reviewed by the DRA, then these efforts will enhance your likelihood of success and their credibility as well. While reviewing physician-owner compensation methodologies, be sure that it also complies with the Stark statute as well.

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