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April 26, 2018

Roy Meidinger
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CONFIDENTIAL ACCOUNTANT-CLIENT COMMUNICATION

RE: Tax Treatment of Illegal Kickbacks

FACTS

1. Under Federal and State law, hospitals which participate in the Medicare and Medicaid programs, are required to charge all private pay patients the same price. The same charge being defined as the actual amount of money being collected. The assumption is all private pay patients are charged the same price and the same debt is created for each private pay patient.

2. An insurance company contracts with a hospital to pay less than the full amount of a patient's bill in full settlement of the patient's obligation.

3. It is assumed that the net reduction in the amount billed by the hospital to the insurance company is deemed to be an illegal kickback.

4. The hospital and the insurance company are both on the accrual method of accounting.

QUESTION

How would the transaction between the hospital and insurance company be reported for tax purposes?

DISCUSSION

1. <u>Illegal Payments</u>

   Generally, deductions are not allowed for payments that constitute a bribe, kickback or other payment that is illegal under any law of the United States or under any generally enforceable law of a state subjecting the payer to a criminal penalty or the loss of license or privilege to engage in a trade or business (IRC 162(c)(2)). Specifically, IRC 162(c)(3) prohibits deductions for any "kickback, rebate, or bribe made by any provider of services, supplier, physician or other person who furnishes items or services for which payment is or may be made under the Social Security Act (including Medicare, Medicaid and TRICARE), or in whole or in part out of Federal funds under a State plan approved under such Act. ... [A] kickback includes a payment in consideration of the referral of a client, patient, or customer."

2. Price Adjustments

Price adjustments that are illegal are generally treated as reductions of the sales proceeds when they are made between the buyer and seller directly, as opposed to reflecting them as nondeductible expenses. However, in cases where the price adjustments are made between the parties other than the buyer and the seller, the sales reported are increased to the original invoice amount, and a corresponding nondeductible expense item is reported for the illegal payment.

We are stipulating that the contractual adjustments are not legally enforceable and therefore, not eligible for offset against sales proceeds. They must be deductions from gross income which are nondeductible.

a. Rebates, discounts, allowances or other payments that are illegal bribes, kickbacks or other illegal payments are treated as deductions from income, and therefore, are not deductible as ordinary and necessary trade or business expenses. Where the parties to the agreement are not the same as the buyer and seller of the underlying product, the rebates or discounts are not adjustments to the purchase price excludable from gross income but deductions from gross income. (Alex v. Comr., 70 T.C. 322 (1978), aff'd, 628 F.2d 1222 (9th Cir. 1980)).

b. An accrual basis taxpayer generally may exclude "contractual allowances" from total receivables in determining gross income if there exists, at the time a service is performed or a good is provided, a legally enforceable contract that provides that the payer incurs a liability for any particular service/good in an amount that is less than the standard billed charge for the same service/good. Where no such contract exists at the time the service is performed or the good provided, however, no exclusion for a "contractual allowance" is warranted (TAM 200619020).

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3. Income Tax Treatment

In general, the tax treatment of the payment of an invoice for less than the total invoice amount can be explained in three steps. The initial step records the total bill for services and supplies delivered. The second step records the assumption of the hospital invoice by the insurer's company. The third step reflects payment of the invoice less than the total invoice amount.

1. Hospital Invoice for Services Rendered

   Hospital Tax Impact

   The initial entry of the hospital would be to record the invoice in the amount of services rendered and other costs billed. The total amount invoiced would be recorded as a receivable from the patient and an equal amount is reported as taxable income by the hospital.

   Income is recorded by the hospital at the time when all the events have occurred which determine the hospital's right to receive it, but not later than the year in which the income is reported on the hospital's financial statements, and the amount can be determined with reasonable accuracy, irrespective of the fact that the taxpayer later forgives the obligation to make the payment (IRC 451(b) and Regs. 1.451-1(a)). This would be at the time services are invoiced to the patient. For tax years ending after 2017, accrual-method taxpayers are required to recognize income that is subject to the all-events test no later than the tax year in which the income is taken into account on the taxpayer's financial statements. IRC 451(b).

2. Hospital Invoice Assumed by the Insurance Company

   Hospital Tax Impact

   The hospital would merely change their billing records to reflect the replacement of the patient's name with the insurance company's name. There would be no tax consequence.

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Insurance Company Tax Impact.

The entry made would be to record the debt to the hospital equal to the amount invoiced by the hospital. The invoice from the hospital would be a deductible trade or business expense of the insurance company (Code Section 162(a)). The time at which the invoice would be deductible by the insurance company would be the taxable year in which (a), all the events have occurred which fix the fact of the liability; (b), the amount can be determined with reasonable accuracy; and (c), economic performance has occurred. Since all the above factors would be met upon the receipt of the invoice by the insurance company, the expense would be deductible at the same time that the hospital invoice is recorded (Code Section 461(h)).

3. Hospital Reduction of the Invoiced Amount as an Illegal Kickback to the Insurance Company

Hospital Tax Impact

The hospital would report a reduction in the amount receivable from the insurance company as an expense item for the payment of a kickback. Illegal kickbacks are nondeductible for tax purposes.

Insurance Company Tax Impact

The insurance company would report the unpaid portion of the hospital liability as taxable income.

A hospital with tax exempt status under code section 501(c)(3) could lose its tax exemption status if the organization is not operated exclusively for its tax exempt purpose. An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Regs. 1.501(c)(3)-1(c)(1). Payments of illegal kickbacks would not be considered as related to its tax exempt purpose and could cause a tax exempt hospital to lose its tax exempt status under Regs. 1.501(c)(3)-1(c)(1).

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A hospital with tax exempt status under code section 501(c)(3), would be required to file a Form 990-T with the Internal Revenue Service to declare the income from the illegal kickback and would also likely be subject to state income taxes on this income.

A hospital that is a political subdivision of a state or locality, which is exempt from income tax under code section 115(1), would also likely have to include the income from illegal kickbacks. Generally, section 115(1) excludes from gross income "income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia." However, income from an illegal kickback would likely not be considered to be income from the exercise of an essential governmental function, and would therefore not be excluded from gross income.

CONCLUSION

For accrual basis taxpayers, the payment of a hospital bill at less than the full amount due to an illegal kickback arrangement results in a nondeductible expense to the hospital equal to the amount of the discount and income to the insurance company in an equal amount.

Sincerely,

GARCIA & ORTIZ, P.A.

Jonathan Marseglia, Esq., C.P.A.

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