

## Taxable Income, Intermediate Sanctions: Unintended Tax Consequences of HIT Donations Due to New Anti-kickback Safe Harbors, Stark Exceptions?<sup>1</sup>

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The U.S. Department of Health and Human Services (HHS) published final regulations effective Oct. 10, 2006 that contain anti-kickback safe harbors and Stark regulatory exceptions allowing permitted donors to donate certain health information technology (HIT) and related services to referral sources. A full description of the final regulations is set forth in our August 2006 advisory bulletin.

Generally, under the new regulations, a permitted donor can pay up to 85 percent of the cost of electronic health record (EHR) software and 100 percent of the cost of e-prescribing software and hardware that it donates to physicians, together with related training and support services. The HIT must meet certain standards, including the requirement that it be interoperable (able to communicate with different HIT systems, software applications, and networks). In addition, the donor and recipient must document the details of the donation in a written agreement prior to the donation.

For tax-exempt hospitals and health systems, the final regulations clear one set of hurdles for donations of HIT, while leaving another in place.<sup>2</sup> Tax-exempt health care entities are governed not only by HHS rules, but are also monitored by the IRS, to ensure that their earnings do not impermissibly benefit individual insiders or for-profit businesses. While the regulations make clear that donations of particular types of technology will not violate the anti-kickback or Stark self-referral laws, many hospitals and health systems may hesitate to engage in such arrangements until they receive assurance that the transactions also will not result in adverse consequences under federal tax law. Currently, the tax outcome is uncertain, which is of particular concern for tax-exempt donors, as well as for physicians who receive the donated technology.

In the face of this uncertainty, tax-exempt donors should consider the potential tax implications before making a donation of HIT to physicians. The nature of the donated HIT, as well as the nature of the recipient, will determine the particular tax issues at stake. As more fully described below, tax-exempt donors should take care to document their consideration of the public benefits served by making a particular donation, and refrain from donating HIT that significantly benefits an insider or a physician's private practice, and all donors should notify recipients in advance if they intend to issue Form 1099s to physicians for the donated value of HIT.

**Prohibition against tax-exempt organizations bestowing a private benefit.** One of the principal concerns of tax-exempt hospitals regarding donation of HIT to physicians is the notion of "private benefit" under the tax rules. The IRS requires that transactions entered into by a tax-exempt entity must serve an exempt purpose and provide a public benefit, rather than create a private benefit for the recipient.<sup>3</sup> A tax-exempt hospital may donate technology that will provide the for-profit or private recipient with some incidental private benefit, as long as it also achieves a significant, predominant public benefit. Any private

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<sup>1</sup> This advisory was not intended or written to be used, and it cannot be used, for the purpose of avoiding penalties that may be imposed under federal tax law. Under these rules, a taxpayer may rely on professional advice to avoid federal tax penalties only if that advice is reflected in a comprehensive tax opinion that conforms to stringent requirements under federal law.

<sup>2</sup> In addition to the applicable tax laws, the HHS final regulations do not pre-empt state anti-kickback and self-referral laws.

<sup>3</sup> Treasury Regulation § 1.501(c)(3)-1(d)(1)(ii). To qualify for tax-exempt status, an organization must establish that it is not organized or operated for the benefit of private interests.

benefit should only be bestowed to the extent necessary to achieve the public benefit. If the transaction mainly benefits the recipient, the donation would violate the tax rules and could lead the IRS to revoke the donor's tax-exempt status. Thus, the question is whether the donation of HIT provides a public benefit, and only an "incidental" private benefit, if any, for the recipient.

Tax-exempt organizations must serve an exempt purpose and benefit the public. The IRS has long recognized the promotion of health as a charitable exempt purpose. Tax-exempt donors may claim that donation of HIT to physicians will further their exempt purpose of promoting health, by helping doctors to safely diagnose, treat, and prescribe for their patients. The technology may help physicians to ensure greater accuracy and safety, and increase the efficiency and quality of patient care. This claim may carry more weight when the individuals served by the physician are also current or potential patients of the exempt hospital, as that would advance the hospital's charitable purposes by improving patient care in an entire community.

Pending specific IRS guidance on the issue, potential tax-exempt donors may find some comfort by defining and documenting the public benefit served by donating HIT to physicians or physician groups. Tax-exempt hospitals can point to legislative history behind the final HHS regulations to support the claim that donating HIT to physicians serves an important public, as opposed to private, purpose. President Bush signed Executive Order 13335 in April 2004, which established widespread adoption of EHR technology within a 10-year period as a national policy priority.<sup>4</sup> The order called for a nationwide interoperable HIT infrastructure that would allow access to a particular patient's health information in multiple settings, whether in the hospital or a doctor's office. In addition, Congress directed the secretary of HHS to establish what resulted in the final regulations. HHS intended those regulations to promote donations of EHR software to physicians in order to improve patient care,<sup>5</sup> as many physicians may not currently have the financial or technical resources to access interoperable HIT.

Tax-exempt hospitals that wish to take advantage of the HHS regulations absent IRS guidelines should take care to document their consideration of the public benefits that will result from donation of HIT to the particular physician-recipient. By doing so, the organization can respond to an IRS inquiry with affirmative evidence that it considered the public-vs.-private benefit issue, rather than attempting to raise the public benefit argument after the fact.

**Requirements under the HHS regulations may limit the potential for direct private benefit to physicians.** The following restrictions on the types of HIT eligible for donation under the HHS regulations, and the manner in which it must be donated, may help a tax-exempt donor hospital to comply with federal tax law by reducing the potential for direct private benefit to physician-recipients.

- Donated HIT must be necessary and used primarily for EHR purposes. The HHS regulations require that the donated HIT be essential, and used predominantly for creating, maintaining, sending, or receiving EHR data. The technology must include electronic prescribing capability. Under these regulations, the recipient may not use the donated HIT primarily to conduct personal business, or business unrelated to the physician's medical practice.
- Restrictions on selecting recipients. The HHS regulations prohibit the donor from selecting recipients of donated HIT resources according to the volume or value of referrals or other business flowing from the physician to the hospital.
- Recipient cannot compel the donation. The physician or his or her staff cannot require the donation, or the type or amount of the donation, as a condition of doing business with the hospital.

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<sup>4</sup> A copy of the executive order is available at <http://www.whitehouse.gov/news/releases/2004/04/20040427-4.html>.

<sup>5</sup> These rules resulted from direction by Congress to the secretary of HHS to establish the anti-kickback safe harbors and Stark exceptions, in order to foster widespread adoption of EHR software.

- HIT must not duplicate a recipient's existing technology. The donor cannot know or have reason to know that the recipient already has technology similar in function or otherwise equivalent to the donated HIT.
- HIT must be interoperable. Donated HIT must be capable of receiving and transmitting patient information within the larger health care system, rather than solely between the parties participating in the particular donation arrangement. The HIT must be interoperable at the time it is donated to the physician.
- Cost-sharing requirement. Physician-recipients must pay at least 15 percent of the donor's cost of purchasing and using donated EHR software prior to receiving the technology or related services. In cases involving customized technology, it may be difficult for the parties to establish the donor's cost. The donating hospital, or any party related to the hospital, cannot finance the recipient's share of the EHR technology.

**Private benefit to physicians from donation of practice management-related HIT.** The final HHS regulations allow donors to donate HIT packages that may include some physician practice-related functions, such as billing and scheduling software, as long as the predominant functions relate to EHR usage. To the extent that these additional functions directly benefit the physician's practice and are not deemed to benefit the community, they may result in private benefit. If they are the predominant aspect of the donated HIT, the donor would violate both the tax law prohibition against private benefit as well as the HHS regulations. Pending IRS guidance on this issue, tax-exempt hospitals may wish to take a conservative approach, and refrain from donating items or services that assist a physician with practice management.

**Intermediate sanctions.** Tax-exempt organizations are prohibited from engaging in or allowing private inurement; i.e., the organization generally may not funnel its net earnings to certain insiders, such as founders, directors, officers, and others who are in a position to exercise substantial influence over the organization's affairs (a "disqualified person").<sup>6</sup> Historically, the IRS had only one weapon against such private inurement: revocation of the organization's exempt status. More recently, Congress added the "intermediate sanctions" provisions to the tax code, which enables the IRS to impose excise tax sanctions on the disqualified person and the organization's managers, rather than revoking the organization's exemption. The intermediate sanction rules apply to hospitals that are tax-exempt under Section 501(c)(3) of the tax code.

Intermediate sanctions apply only when an exempt organization provides an "excess benefit" to a disqualified person. An excess benefit occurs when the value that the organization provides to the disqualified person exceeds the value of any benefit that the disqualified person provides to the organization in return.<sup>7</sup> When a tax-exempt hospital donates 85 percent of the cost of HIT to a physician or physician group, the hospital will not receive a return benefit in exchange for the donation, since it is a gift. Therefore, the donation will confer an excess benefit, and may be subject to the intermediate sanctions rules, if the physician-recipient is a disqualified person with respect to the donor.

While physicians who receive donated HIT may not appear to be insiders of the tax-exempt hospital making the donation, the intermediate sanctions may apply if the physician-recipient was in a position to exercise substantial influence over the hospital's affairs within the five-year period prior to the donation. Whether a physician is in a position to exercise substantial influence depends upon all of the facts and circumstances. Pending IRS guidance on this issue, tax-exempt donors should consult their tax counsel prior to donating HIT to physicians who may be disqualified persons with respect to their organizations.

**Potential taxable income to the recipient of donated HIT.** Generally, when either a taxable or tax-exempt organization pays compensation, remuneration, or other payments to a non-employee, the

<sup>6</sup> Section 4958 of the Internal Revenue Code of 1986, as amended (the "Code").

<sup>7</sup> Section 4958(c)(1) of the Code; Treasury Regulation § 53.4958-4(a)(1), (2).

organization must furnish a Form 1099 information return both to the recipient and the IRS. Absent IRS guidance on this issue, it is currently uncertain whether donated HIT constitutes “income” for these purposes. If the donor is providing the HIT primarily for the benefit of a hospital and its patients, with no more than an insubstantial benefit flowing to the physician-recipient, the donation may not constitute income to the physician.

Alternatively, the donor may claim that the HIT is a working condition fringe benefit under the tax law, so the donor is not required to report its value on Form 1099. A working condition fringe benefit consists of property or services that can only be used in connection with an employer’s purposes, and the employer must derive a substantial business benefit from providing the fringe benefit.<sup>8</sup> In order to make this claim, the donor must establish that the recipient is an independent contractor for the donor.<sup>9</sup> The HHS regulations may make this argument more difficult, as they require that the HIT be interoperable so the recipient can use it with other parties, rather than just the donor. The anti-kickback statute generally prohibits hospitals and health systems from making such a donation to induce physicians to refer business to the donor, which limits the parties’ ability to claim that the donor derives a substantial business benefit from the donation.

If, however, the HIT provides a private benefit to the physician, such as software applications for general office purposes, that portion may constitute income. In that case, both taxable and tax-exempt donors should issue a Form 1099 for the amount of the private benefit. The same analysis would then apply to any donated services in connection with the HIT that are incidentally used for general office purposes. The donor could allocate part of the total cost of the HIT and related services to the practice management technology, and issue a Form 1099 for that portion to the physician.

Potential recipients of donated HIT may be apprehensive about accepting the donation when they learn that it could give rise to additional tax liability. If a taxable or tax-exempt donor will issue a Form 1099 to the recipient, the donor should inform the recipient prior to making the donation, to avoid unpleasant surprises for the physician.

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<sup>8</sup> See Section 132(d) of the Code.

<sup>9</sup> Treasury Regulation § 1.132-1(b)(2).