Compensation Paid by Healthcare Providers

Physician compensation continues to be an especially important issue due to extensive integration of medical practices into larger healthcare systems and the severe penalties for non-compliance. Healthcare providers should carefully consider the following three important sets of rules when preparing compensation plans:

1. Federal Income Tax

Hospitals and other healthcare providers need to ensure that they pay only “reasonable compensation” in order to comply with the Internal Revenue Code and IRS regulations, regardless of whether the payer is for-profit or tax exempt. (Other whitepapers on this website provide further details of these income tax regulations and offer broad recommendations for avoiding penalties and assessments.)

2. State and Local Tax

Healthcare providers operating as tax-exempt entities need to be careful to comply with state and local laws in order to maintain their exempt status. (Their exemption from local property taxes and sales taxes may be completely independent of their exemption from federal income tax.) If they pay more than reasonable compensation to physicians, for example, the benefit of the organization’s resources may be considered to have inured to the benefit of those physicians. This could result in loss of exempt status for purposes of property taxes and/or sales taxes, if local law provides that *no* benefits may inure to an individual.

Local laws may also state that the financial resources of an exempt organization must be used *exclusively* for exempt purposes.

State and local requirements vary across the country, so please check with a local attorney. But state and local regulations should not be overlooked. If an organization becomes subject to local property taxes on its real property and equipment, the amount of tax that has to be paid annually may be substantial.

3. Reimbursement

In addition, healthcare providers need to ensure that the compensation they pay to physicians is “fair market value” and “commercially reasonable.” Federal rules for this purpose vary from the federal income tax regulations.

Some important guidelines for determining what is fair market value and what is commercially reasonable have been derived from case law. Perhaps the most publicized litigation in this area has been that of Tuomey Healthcare System. However, “fair market value” is found in the Stark statute at 42 U.S.C. § 1395nn (h)(3):

> “The term “fair market value” means the value in arms length transactions, consistent with the general market value, and, with respect to rentals or leases, the value of rental property for general commercial purposes (not taking into account its intended use) and, in the case of a lease of space, not adjusted to reflect the additional value the prospective lessee or lessor would attribute to the proximity or convenience to the lessor where the lessor is a potential source of patient referrals to the lessee.”

In addition, the Centers for Medicare and Medicaid Services (CMS) provide the following definition of fair market value at 42 CFR § 411.351:

> *“Fair market value* means the value in arm's-length transactions, consistent with the general market value. “General market value” means the price that an asset would bring as the result of *bona fide* bargaining between well-informed buyers and sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of *bona fide* bargaining between well-informed parties to the agreement who are not otherwise in a position to generate business for the other party, on the date of acquisition of the asset or at the time of the service agreement. Usually, the fair market price is the price at which *bona fide* sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition, or the compensation that has been included in *bona fide* service agreements with comparable terms at the time of the agreement, where the price or compensation has not been determined in any manner that takes into account the volume or value of anticipated or actual referrals. With respect to rentals and leases described in § 411.357(a), (b), and (l) (as to equipment leases only), “fair market value” means the value of rental property for general commercial purposes (not taking into account its intended use). In the case of a lease of space, this value may not be adjusted to reflect the additional value the prospective lessee or lessor would attribute to the proximity or convenience to the lessor when the lessor is a potential source of patient referrals to the lessee. For purposes of this definition, a rental payment does not take into account intended use if it takes into account costs incurred by the lessor in developing or upgrading the property or maintaining the property or its improvements.”

Additional commentary on “fair market value” was provided at *66 Fed. Reg. 944, January 4, 2001* and *69 Fed. Reg. 16107, March 26, 2004*.

The following description of "commercial reasonableness" is provided in the regulatory commentary at *66 Fed. Reg. 919, January 4, 2001*:

> "With respect to determining what is "commercially reasonable," any reasonable method of valuation is acceptable, and the determination should be based upon the specific business in which the parties are involved, not business in general. In addition, we strongly suggest that the parties maintain good documentation supporting valuation. Finally, with respect to difficult cases, the parties could seek an advisory opinion under section 1877 of the Act. (See § 411.370.) However, we cannot express opinions on whether compensation represents fair market value. (See § 411.370(c)(1).) For further discussion of "fair market value", see section VIII.B.3 of this preamble."

Additional guidance on the meaning of "commercial reasonableness" is provided at *69 Fed. Reg. 16093, March 26, 2004*:

> "An arrangement will be considered "commercially reasonable" in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician (or family member or group practice) of similar scope and specialty, even if there were no potential DHS referrals."

In addition to being fair market value and commercially reasonable, each compensation plan should avoid compensating the doctor for referrals. The physician's "compensation arrangement" must not be one that "varies with, or takes into account, the volume or value of referrals or other business generated by the referring physician." See 42 CFR § 411.354 (c). However, unit-based compensation arrangements that are set in advance are permitted if strict requirements are met. These rules are described throughout the Stark regulations and commentary, including 42 CFR § 411.354 (d):

> "*Special rules on compensation.* The following special rules apply only to compensation under section 1877 of the Act and subpart J of this part:
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>> (1) Compensation is considered "set in advance" if the aggregate compensation, a time-based or per-unit of service-based (whether per-use or per-service) amount, or a specific formula for calculating the compensation is set in an agreement between the parties before the furnishing of the items or services for which the compensation is to be paid. The formula for determining the compensation must be set forth in sufficient detail so that it can be objectively verified, and the formula may not be changed or modified during the course of the agreement in any manner that takes into account the volume or value of referrals or other business generated by the referring physician.

(2) Unit-based compensation (including time-based or per-unit of service-based compensation) is deemed not to take into account “the volume or value of referrals” if the compensation is fair market value for services or items actually provided and does not vary during the course of the compensation arrangement in any manner that takes into account referrals of DHS.

(3) Unit-based compensation (including time-based or per-unit of service-based compensation) is deemed not to take into account “other business generated between the parties,” provided that the compensation is fair market value for items and services actually provided and does not vary during the course of the compensation arrangement in any manner that takes into account referrals or other business generated by the referring physician, including private pay health care business (except for services personally performed by the referring physician, which are not considered “other business generated” by the referring physician).

(4) A physician's compensation from a *bona fide* employer or under a managed care contract or other contract for personal services may be conditioned on the physician's referrals to a particular provider, practitioner, or supplier, provided that the compensation arrangement meets all of the following conditions. The compensation arrangement:

(i) Is set in advance for the term of the agreement.
(ii) Is consistent with fair market value for services performed (that is, the payment does not take into account the volume or value of anticipated or required referrals).
(iii) Otherwise complies with an applicable exception under § 411.355 or § 411.357.
(iv) Complies with both of the following conditions:
(A) The requirement to make referrals to a particular provider, practitioner, or supplier is set forth in a written agreement signed by the parties.
(B) The requirement to make referrals to a particular provider, practitioner, or supplier does not apply if the patient expresses a preference for a different provider, practitioner, or supplier; the patient's insurer determines the provider, practitioner, or supplier; or the referral is not in the patient's best medical interests in the physician's judgment.
(v) The required referrals relate solely to the physician's services covered by the scope of the employment or the contract, and the referral requirement is reasonably necessary to effectuate the legitimate business purposes of the compensation arrangement. In no event may the physician be required to make referrals that relate to services that are not provided by the physician under the scope of his or her employment or contract.

"DHS" as used above is defined by § 411.351:

> "*Designated health services (DHS)* means any of the following services (other than those provided as emergency physician services furnished outside of the U.S.), as they are defined in this section:
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> (1) Clinical laboratory services.
> (2) Physical therapy, occupational therapy, and outpatient speech-language pathology services.
> (3) Radiology and certain other imaging services.
> (4) Radiation therapy services and supplies.
> (5) Durable medical equipment and supplies.
> (6) Parenteral and enteral nutrients, equipment, and supplies.
> (7) Prosthetics, orthotics, and prosthetic devices and supplies.
> (8) Home health services.
> (9) Outpatient prescription drugs.
> (10) Inpatient and outpatient hospital services.
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> Except as otherwise noted in this subpart, the term "designated health services" or DHS means only DHS payable, in whole or in part, by Medicare. DHS do not include services that are reimbursed by Medicare as part of a composite rate (for example, SNF Part A payments or ASC services identified at § 416.164(a)), except to the extent that services listed in paragraphs (1)(i) through (1)(x) of this definition are themselves payable through a composite rate (for example, all services provided as home health services or inpatient and outpatient hospital services are DHS)."
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> The above description of DHS can be found at: http://www.cms.gov/Medicare/Medicare-Fee-for-Service Payment/ClinicalLabFeeSched/downloads/411_351.pdf

Please Note: The above is only a brief description of a complex area of law. This information is provided solely to encourage meaningful discussion and is not intended to be legal advice or other advice for any particular set of facts. In preparing compensation opinion letters, Stephen Kirkland works only in conjunction with healthcare providers that have well-qualified legal counsel that is also deeply involved in the process.