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Use Caution When Structuring Physician Loan Agreements to Protect Physicians Against Income Recognition on the Transfer of Funds

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Earlier this year, a federal court called into question the tax treatment of physician loans, a practice common among hospitals and physician groups to attract top talent.

The U.S. District Court for the Western District of Washington held in *Vancouver Clinic, Inc. v. United States,* No. 3:12-cv-05016-RBL (W.D. Wash. Apr. 8, 2013), that advances paid by a medical clinic to newly hired physicians were part of the physicians' compensation packages rather than loans because the parties never intended or anticipated any repayment. Instead, these advances were merely meant to induce the physicians to stay with the clinic for a certain term. The repayment provision of the agreement essentially functioned as a liquidated damages clause, which was triggered if a physician terminated employment prior to expiration of the term.

Position of the IRS

The agreements in question were each titled "Associate Physician Loan Agreement," and each required a new physician to work for the clinic for a period of five years in exchange for two advances of funds to the physician during the physician's first and second years of employment. These advances ranged from $12,000 to $35,000, depending on the physician's specialty and the difficulty in recruiting the physician. The physician had to repay the advance only if the physician broke the contractual promise to remain employed by the clinic for at least five years. Although interest accrued at the prime rate over the five-year term of the agreement, the physician was not required to pay any interest so long as the physician continued working at the clinic. The physician was free to accept or reject the agreement, and some did reject it.

At issue were withholding and FICA taxes totaling nearly $600,000 that the Internal Revenue Service (IRS) claimed the clinic owed. The clinic did not report any income to the physicians when the alleged loans were made but did report income to them at the time the loans were forgiven. The IRS challenged this treatment, claiming that the physicians were required to recognize the cash as income when received on the grounds that the transfers were not loans for tax purposes.

Key Question: The Parties' Intent

In determining whether loans by an employer to an employee are taxable as income, the court identified two key inquiries: (1) whether there was an unconditional promise to repay at the time the funds were advanced; and (2) whether the parties actually intended for the advance to be repaid at the time it was made.

The court noted that a "transaction is not a loan if the parties do not intend repayment at the time it is entered into." Determining the parties' intent is a factual question that "requires examining the facts and circumstances surrounding the exchange." Thus, each case will be decided on its own merits. However, the court in this case was persuaded by the fact that the physicians had, at the outset, fully expected to fulfill their promises to work at the clinic for five years and, as a result, to have their loans forgiven. Similarly, the clinic fully expected that the physicians would serve for five years at a minimum. The court was also influenced by the fact that repayment occurred "only in the exceptional case." The court further noted that there were no financial background investigations or credit checks to evaluate the physicians' creditworthiness prior to advancing the funds.

Loan or Compensation?

Courts will consider a number of "non-exclusive" factors in determining whether a transaction represents a bona fide loan, including:

1. Whether the promise to repay is evidenced by a note or other instrument;
2. Whether interest was charged;
3. Whether a fixed schedule for repayments was established;
4. Whether collateral was given to secure payment;
5. Whether repayments were made;
6. Whether the borrower had a reasonable prospect of repaying the loan and whether the lender had sufficient funds to advance the loan; and
7. Whether the parties conducted themselves as if the transaction were a loan.

Welch v. Comm'r, 204 F.3d 1228, 1230 (9th Cir. 2000) (cited in *Vancouver Clinic* at *4).

Practical Takeaways

While the *Vancouver Clinic* case has not yet been cited in other jurisdictions, it illustrates the IRS' view that transactions structured as physician recruitment loans may be considered compensation at the time funds are transferred to the physician rather than actual loans, which would give rise to compensation to the physician only upon later forgiveness. The IRS determined that the key factor was whether the parties intended the funds to be repaid. To maximize the likelihood that recruitment loans will be treated as true loans for federal income tax purposes, care should be taken in drafting physician loan agreements to ensure that they meet as many of the above factors as possible. In addition, employers may want to conduct and document careful credit checks on physicians, negotiate different terms depending on the creditworthiness of the borrower, and structure the loan to accrue interest at a rate at least equal to the Applicable Federal Rate.

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