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Physician Denied Deduction for Repayments of Tuition Triggered by Failure to Meet Service Requirement

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Take Heed of the Tax Consequences for Repayment of Tuition and Other Types of Payments

In a recent decision, *Dargie v. United States* (6th Cir. 2014), the Sixth Circuit Court of Appeals found that a physician could not deduct as a business expense a payment that he made to a medical facility in repayment of the tuition, fees, and expenses previously paid by the facility for the physician's medical school education. Shortly after enrolling as a student in medical school, Dr. Dargie entered into an agreement with his medical school and Middle Tennessee Medical Center (MTMC), a Murfreesboro hospital that provided services in a medically underserved area. In return for the facility's payment of his tuition, fees, and other reasonable expenses of attending medical school, Dr. Dargie agreed to serve as a doctor in the Murfreesboro, Tenn. area for a period of four years after he became licensed to practice medicine in which case he was not required to repay the amounts paid for by the medical facility on his behalf. Alternatively, he was required to repay two times the amount paid by MTMC or a lesser amount if agreed to by his medical school.

Upon completion of his medical training some seven years after entering into the agreement with the medical facility, Dr. Dargie elected to practice medicine in another part of Tennessee that was outside of the Murfreesboro area served by MTMC. The next year he repaid the amount paid by MTMC ($73,000) on his behalf plus interest on this amount (another $48,440, for a total of $121,440) in full satisfaction of his obligations under the agreement with MTMC and his medical school.

In an amended tax return filed for the calendar year in which he repaid the $121,440 to MTMC, Dr. Dargie sought to deduct the full amount of the repayment as "damages" and

sought a recalculated refund of $30,304 plus interest. After the Internal Revenue Service (IRS) denied the refund, Dr. Dargie filed a suit for refund in a local federal district court. The district judge denied the refund sought by Dr. Dargie in the amended return and indicated that payments by an individual to meet the minimum requirements for practicing in a given profession are personal expenses and not deductible business expenses.

In denying Dr. Dargie's appeal of the district court decision, the United States Sixth Circuit Court of Appeals agreed with the IRS, upheld the district court's denial of the refund, and reasoned that the court needed to examine the nature and origin of the claim as to which the expense was incurred — in this case, the payment was made by MTMC on Dr. Dargie's behalf to provide him with the required educational requirements to practice medicine. Even if paid by Dr. Dargie only after he became a physician, the payments are still not deductible by him since the payments would not have been deductible if paid while he attended medical school.

This case illustrates yet another aspect of the tax consequences of the "loan and forgiveness model" that this author discussed in an article that appeared in the September-October 2013 issue of this publication called "*Beware of the Tax Consequences of Physician Recruitment Payments*." Under the loan and forgiveness model, a newly recruited physician receives a payment from an employer, which payment need not be repaid (as if the payment were a loan) if the physician meets certain pre-negotiated service requirements for the employer. The federal district court decision discussed in last year's article (*Vancouver Clinic, Inc. v. United States*) ruled that since the obligations of the physicians who received these payments to repay them to the taxpayer, a multipractice physician group, were not properly documented as loans, the physicians should have reported the payments in income in the year in which the payments were received and the practice group should have withheld taxes against the amounts paid to the physicians and paid employment taxes on the recruitment payments.

Most prospective employers that structure recruitment payment arrangements using the "loan and forgiveness model" treat the payments as income to the recipient-professional in the year in which the obligation to repay the "loan" is forgiven *and not* as income to the physician in the year in which the payment is made by the employer (as the court decided was proper in the *Vancouver Clinic* case). The *Dargie* case illustrates the tax consequences in the use of the loan and forgiveness model for payments made not by a prospective employer but by a medical facility that tries to incentivize medical students to practice medicine in the medically underserved area that the facility serves after they become licensed physicians.

Since no employment relationship was contemplated in the *Dargie* case, there should not have been tax consequences to Dr. Dargie upon MTMC's payment of medical school tuition, fees, and other expenses on his behalf, upon his meeting the service requirements imposed by his agreement with the facility or by his repayment to MTMC of the amounts paid on his behalf if he did not satisfy the service requirements contained in the agreement with MTMC and his medical school. Neither the federal district court nor the Sixth Circuit Court of Appeals indicated otherwise (no finding of income upon payment by MTMC on behalf of Dr. Dargie, upon his meeting the service requirements, or upon his repayment to MTMC of the amounts paid on his behalf plus interest). Only by the physician's ill-fated attempt to deduct the payments made as "damages" did the tax issues posed by this variation of the loan and forgiveness model arise.

In helping clients structure payments of the type made in the *Vancouver Clinic* and *Dargie* cases, advisors should take heed of the tax consequences to both the employer/other payor of the amounts paid and the professional who receives the benefit of these payments.

Reprinted from Journal of Health Care Compliance, Volume 16, Number 3, May-June 2014,
pages 53–54, with permission from CCH and Aspen Publishers, Wolters Kluwer businesses.