

## CLIENT ALERT

### IRS Expands Period for Provider Incentive Payment Deductibility

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New Internal Revenue Service guidance gives health insurers and health maintenance organizations (HMOs) more than 2 ½ months from the end of their tax year to make provider incentive payments and still take the related deduction in the earlier tax year. This guidance is set forth in Rev. Proc. 2004-41, 2004-30 I.R.B. 90 (July 26, 2004), <http://www.irs.ustreas.gov/pub/irs-irbs/irb04-30.pdf>. The new guidance is applicable not only to traditional capitation-based or utilization cost incentive programs, but also to newer “pay for performance” initiatives aimed specifically at improving quality, patient satisfaction and health care outcomes.

The Revenue Procedure was developed through the Industry Issue Resolution program, which addresses tax issues that are frequently disputed in a particular industry.

Many health insurance companies and HMOs have arrangements with physicians, groups of physicians and other health care providers under which incentive payments are made to the health care providers for meeting objectives related to providing quality health care in a cost-efficient manner. These payments may be structured as hold-backs or bonus payments. Because the determination whether the objectives have been met often is based on data that can only be collected after the end of the payer’s taxable year, there is a tax issue as to the tax year in which the deduction is allowable.

If the health insurance company or HMO is permitted to take the tax deduction with respect to the payment in the year in which the services are performed, but delay the payment until a subsequent year, there may be a mismatch in the timing of the deduction and the related income. The health care provider frequently is an individual or an entity that computes its tax liability on the cash basis of accounting, and therefore often may pay income tax with respect to the payment in the year of payment.

Because of the potential for a timing mismatch, section 404 of the Internal Revenue Code provides that normally the company cannot take a deduction for “deferred compensation” payments for the year for which the incentive payment applies if they were made more than 2 ½ months after the end of the taxable year. Recognizing that these companies face unique administrative challenges in performing the relevant calculations, and often need more than 2 ½ months to collect the necessary data and complete those calculations, the IRS has created a safe harbor in the Revenue Procedure under which the deduction is allowable without reference to the requirements of Code section 404. Accordingly, if the payments meet the requirements of Rev. Proc. 2004-41, these companies will not be held to the 2 ½ month period otherwise applicable under Code section 404.

To qualify, the payment must qualify as a “provider incentive payment.” Some of the requirements for a provider incentive payment include the following:

- The arrangement must be in writing;
- The purpose of the arrangement is to encourage participating health care providers to provide quality health care to the taxpayer’s subscribers in a cost-efficient manner;

- Tax deferral by the providers must not be a principal purpose of the arrangement;
- The performance period may not exceed 12 consecutive months;
- Normally, the taxpayer must make payments pursuant to the arrangement within 12 months of the close of the performance period.
- The terms of the arrangement must be established unilaterally rather than pursuant to a negotiation with the providers;
- The health care provider may not be an employee or agent of the taxpayer;
- The taxpayer must record a liability in an appropriate amount on its annual statement filed for state regulatory purposes.

Taxpayers that are currently not accelerating their deductions as permitted by Rev. Proc. 2004-41 may use the automatic change in method of accounting procedures pursuant to Rev. Proc. 2002-9, with modifications. Department of Health & Human Services provider incentive plan regulations and antitrust considerations also can affect the scope and structure of provider incentive arrangements. Incentive programs should be implemented in accord with the full range of applicable compliance requirements.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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