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Brooklyn Federal District Court Holds That Interest Payable to Tax-Exempt Corporation on Tax Refunds Is Limited to Short-Term AFR Plus 0.5 Percentage Points

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On September 19, the U.S. District Court for the Eastern District of New York held that a tax-exempt hospital (Maimonides Medical Center) organized as a not-for-profit corporation under state law is to be treated as a “corporation” for purposes of determining the interest payable by the IRS on tax refunds. The Court’s holding led to the conclusion that the interest payable by the IRS is limited to the short term AFR plus 0.5 percentage points, which is the lowest of the three possible interest rates that were at issue in the dispute.

This decision is the first in a series of pending cases and was issued in response to the government’s summary judgment motion.

The issues that the Court considered and its analysis can be summarized as follows:

A. Does the tax-exempt status of a hospital organized as a not-for-profit corporation under state law cause it to be considered as specially treated under the Internal Revenue Code (Code)?

This is critical because if an entity is considered subject to special treatment under the Code, it avoids “corporation” status and would be entitled to interest of short-term AFR plus 3 percentage points on tax refund claims.

In answering this question, the Court focused on the one example provided by the regulations on when an entity is considered as specially treated by the Code—this would be Code Section 860A with respect to Real Estate Mortgage Investment Conduits (REMICs). That provision states that REMICs are not subject to taxation, are not treated as

corporations, and a REMIC’s income is taxable to the holders.

The Court stated that tax-exempt status alone is not to be considered as special treatment under the Code. The Court noted that tax exempt status is “arguably ‘special,’” but not sufficiently special to avoid corporation status under the check-the-box regulations. The Court referenced the fact that the Code provides tax-exempt status to corporations that are organized and operated exclusively for a qualifying purpose. Accordingly, the statute (Code Section 501(c)) acknowledges that entities can be classified as both corporations and tax exempt. In contrast, the REMIC provision which is used in the regulations specifically states that such entities are not to be treated as corporations and, in fact, are not taxed at the entity level. Later in its analysis, the Court mentions the fact that the same regulations reference tax exempt entities as corporations.

The Court neatly presents the points that the hospital counsel would have to overcome. The Court was unwilling to give further consideration as to what should be meant as special treatment under Code and wanted additional authority for the position that a tax-exempt entity should qualify as specially treated under the Code (or under the classification regulations).

Once the Court concluded that tax-exempt hospitals do not have special treatment under the Code, it was unwilling to listen to the hospital’s discussion that not-for-profit hospitals should be distinguished from for-profit organizations.

B. On the conclusion that tax-exempt hospitals are corporations, is there merit to the positions that (1) only C corporations are to receive the lowest interest rate payable on tax refunds, and (2) tax-exempt hospitals are not C corporations?

The Court concluded that the interest rate of short-term AFR plus 0.5 percentage points payable on tax refunds applies to all corporations with claims exceeding \$10,000. Stated simply, once the entity was held to be a corporation for classification purposes, the applicable interest rate on tax refunds fell in line.

For various reasons, a Tax Court decision (Garwood Irrigation Co.), which held that the lowest interest rate is applicable only to C corporations, was said to be not controlling. This is an even more technical argument, and the Court had no interest in looking any further than the simple language of the main statutory provision at issue. Separate from the technical argument, the Court was not interested in positions of how the Internal Revenue Manual nor other policy arguments should impact this point.

Even if the Court had accepted that the lowest interest rate on tax refunds is limited to C corporations, there were additional hurdles for the hospital to overcome that the Court did not need to address.

A last comment is that the Court's decision includes criticisms regarding the hospital's positions that could influence a judge's view in pending disputes in other federal courts. Among its criticisms, the Court stated that one position put forth by the hospital was "quite simply, patently incorrect," that a compelling case was made for the most advantageous interest rate that Congress could provide to hospitals but that Congress did not provide it, and that the only evidence in the record to support another hospital position was the unsworn or affirmed statement of the hospital's counsel.

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