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Interest Payable to Tax-Exempt Corporations on Tax Refunds

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Tax-exempt teaching hospitals have been receiving FICA tax refunds in settlement of claims that amounts paid to certain medical students are exempt from this tax. An issue has surfaced regarding the appropriate interest payable by the IRS on the tax refund amount. These refund claims can span almost 20 tax years, with the effect that the application of a higher compounded interest could yield a substantial amount.

At issue is whether the interest payable on the FICA tax refund claims should be the Short Term Applicable Federal Rate (AFR) plus (A) 0.5 percentage points (which is the IRS position), (B) 2 percentage points, or (C) 3 percentage points (which some hospitals argue). In general, individuals are entitled to AFR plus 3 percentage points, corporations are entitled to AFR plus 2 percentage points, and C corporations that make a tax overpayment in excess of $10,000 are entitled to AFR plus 0.5 percentage points.

The focus of the disagreement is threefold:

1. Whether a tax-exempt teaching hospital organized as a not-for-profit corporation under state law should be treated as a "corporation" for this purpose,
2. If yes, whether the lowest interest receivable on tax refunds (i.e., AFR plus 0.5 percentage points) is only applicable to C corporations, and
3. Whether a tax-exempt teaching hospital organized as a not-for-profit corporation under state law should be treated as a C corporation.

A few hospitals are litigating the issue of the interest payable by the IRS and briefs in support of motions for summary judgment were filed by two such hospitals in March. Maimonides Medical Center (Brooklyn, New York) and Detroit Medical Center have summary judgment motions pending. Miami Valley Hospital/Good Samaritan Hospital (Dayton, Ohio) commenced litigation on May 13.

The three hospitals in the cases currently pending have taken the position that a tax-exempt teaching hospital organized as a not-for-profit corporation under state law is not a corporation for purposes of the tax overpayment interest rate rules. If successful, this position would yield the highest interest rate receivable, AFR plus 3 percentage points. The IRS argues that the lowest interest rate is applicable to all forms of corporations (for-profit and not-for-profit), even if they are tax-exempt for federal income tax purposes.

The U.S. Tax Court held in 2006 that the overpayment interest rate of AFR plus 0.5 percentage points only applies to C corporations that make an overpayment of tax in excess of $10,000 and, accordingly, an S corporation was entitled to the overpayment interest rate of AFR plus 2 percentage points because the entity was a corporation, but not a C corporation. This decision goes part of the way in support of a middle ground that tax-exempt teaching hospitals organized as corporations under state law are "corporations" but are not "C corporations" and should be entitled to the overpayment interest rate of AFR plus 2 percentage points, rather than the overpayment interest rate of AFR plus 0.5 percentage points. Nonetheless, the IRS does not have a position regarding whether this decision has any application outside of the S corporation context.

The issue of whether a charitable tax-exempt teaching hospital organized as a not-for-profit corporation under state law is a "corporation" or a "C corporation" is found in definitions provided by the federal income tax regulations and the Internal Revenue Code. Except for some loose

language, these definitions are rather cut and dried and leave only limited room for ambiguity. This is the position put forth by the government on this issue. The hospitals argue that these terms should be interpreted more narrowly in a manner consistent with a more general understanding of a business entity and that the special tax treatment provided to tax-exempt organizations excludes such organizations from being considered as business entities. In addition, the hospitals argue that Congress never intended a tax-exempt organization to qualify as a C corporation, to which the lowest interest rate is payable. These policy arguments would require that a court look beyond the language of the statute and regulations.

It is worth noting that some teaching hospitals qualify as an integral part of the state (e.g., state university affiliated hospitals). In these situations, the IRS acknowledges that organizations within this category should not be treated as corporations and has paid them the overpayment interest rate of AFR plus 3 percentage points on their FICA tax refund claims.

Without going into great detail, tax-exempt teaching hospitals organized as not-for-profit corporations under state law that are not an integral part of the state and that are interested in pursuing a higher rate of interest in excess of 0.5 percentage points on their FICA tax refunds should consider the strength of the following positions in determining whether to commence litigation:

a) Tax-exempt teaching hospitals organized as not-for-profit corporations under state law are not "corporations" and should be entitled to the overpayment interest rate of AFR plus 3 percentage points. With respect to the position that tax-exempt teaching hospitals organized as not-for-profit corporations are not "corporations," corporations are defined to include any entity recognized for federal income tax purposes that is not subject to special treatment under the Internal Revenue Code. Entities within this category are labeled "business entities" and "eligible entities." A hospital's position would be that tax-exempt hospitals that are not-for-profit corporations under state law are not "business entities" or "eligible entities" because they are specially treated under the Internal Revenue Code. At issue is what does it mean to be specially treated under the Internal Revenue Code so as not to be treated as a "business entity" or "eligible entity"? More specifically, does tax-exempt status under the Internal Revenue Code qualify as special treatment or is the referenced special treatment more limited?

b) Tax-exempt teaching hospitals organized as not-for-profit corporations under state law may be "corporations" but are not "C corporations" and thus should be entitled to the overpayment interest rate of AFR plus 2 percentage points. If there is a concession that exempt teaching hospitals organized as not-for-profit corporations under state law are "corporations," there is still the backup position that AFR plus 2 percentage points should be paid, rather than AFR plus 0.5 percentage points. This position is based on the argument that the lowest rate is applicable only to C corporations and that tax-exempt hospitals organized as not-for-profit corporations under state law are not C corporations.

As mentioned above, a 2006 Tax Court decision supports the position that the overpayment interest rate of AFR plus 0.5 percentage points is applicable only to C corporations. The tax refund in that decision involved an S corporation's overpaid corporate level built-in gain tax. The Tax Court interpreted the relevant interest statute consistent with the taxpayer's argument that the lowest interest rate is limited to C corporations. Further, it was easy for the Tax Court in that case to conclude that an S corporation is not a C corporation. The Tax Court concluded that the overpayment interest rate of AFR plus 2 percentage points was payable to an S corporation.

The 2006 Tax Court decision could be extended to tax-exempt teaching hospitals organized as not-for-profit corporations under state law but only if a court would also accept that such hospital should not be treated as a C corporation. The statutory definition of C corporation is very broad. Over the years, regulations have been issued in different contexts stating that tax-exempt organizations should not be treated as C corporations. These regulations could be used as examples that the IRS acknowledges that tax-exempt organizations were never intended to be treated as C corporations. Further, on a more general basis, an argument can be made that the reference to C corporations is limited to entities subject to the provisions of Subchapter C of the Internal Revenue Code, and such

provisions are generally inapplicable to tax-exempt organizations.

The arguments for and against these positions have been summarized by the briefs in support of the motions made in the pending cases. The pending cases have been filed in U.S. district courts, which is one of the normal venues for pursuing disallowed refund claims. Surprisingly, the one decision that provides the best analysis on a portion of the relevant issue was decided by the U.S. Tax Court. Normally, the Tax Court has no jurisdiction to hear issues related to refund claims, but the decided cases had a different history.

Tax-exempt teaching hospitals that would like to maintain the validity of their refund claims for the higher interest payable without having to commence litigation should consider whether the IRS would grant extensions (IRS Form 907) until the current litigation is resolved. Absent the availability of extensions, tax-exempt teaching hospitals would have a limited time to commence litigation following the disallowance of their refund claims or have their refund claims lapse.

FOR MORE INFORMATION

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