INSIGHTS FROM THE BDO CENTER FOR HEALTHCARE EXCELLENCE & INNOVATION

UNDERSTANDING THE TAXATION OF TELEHEALTH

By Spiro Leunes, CPA, MS, Tax Partner, BDO Center for Healthcare Excellence & Innovation

The COVID-19 pandemic necessitated the quick adoption of telehealth within the U.S. healthcare system. Through the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the federal government has provided incentives and deregulation so that telehealth is no longer an outlier, but instead an integral way patients interact with healthcare professionals.

As telehealth is adopted, the federal and state governments will have complex tax issues to address. Currently, a patchwork of state statutes, regulations and judicial decisions, inclusive of the Supreme Court of the United States, govern state taxation and guide how providers apply state taxation to telehealth services. However, federal guidance is lacking. To effectively navigate next steps, healthcare leaders must understand current tax guidance as it relates to telehealth and improve their awareness of state tax jurisdictions or "nexus" with respect to state income tax purposes.

TELEHEALTH DEFINED

Telehealth and telemedicine, as defined by the Health Resources and Services Administration, a division of the U.S. Department of Health & Human Services (HHS), is the use of electronic information and telecommunications technologies to support and promote long-distance clinical healthcare, patient and professional health-related education, public health and health administration.

Telehealth applications include:

- **Store-and-forward (asynchronous) videoconferencing:** the transmission of a recorded health history to a health practitioner (usually a specialist)
- **Remote patient monitoring (RPM):** the use of connected electronic tools to record personal health and medical data in one location for review by a provider in another location, usually at a different time
- **Mobile health (mHealth):** healthcare and public health information provided through mobile devices

CARES ACT PAVES THE WAY

The CARES Act granted the secretary of HHS the authority to waive the requirements of the Social Security Act for easier implementation of telehealth services during the COVID-19 crisis. Since Congress enacted the CARES Act, the idea of permanently removing restrictions to telehealth use has received **bipartisan congressional support**, with loosening geographic restrictions and expanding Medicare and Medicaid reimbursement for such services among priorities.

Changes the government has made to date include allowing federal qualified health centers and rural health clinics to provide telehealth services to Medicare beneficiaries. Additionally, people can use high-deductible health plans with health savings accounts to pay for telehealth services, and providers can use telehealth to provide home dialysis and veterans programs.

The government also approved funding via federal agencies to support providers in their expansion of telehealth. HHS received $27 billion, and the Federal Communications Commission has received $200 million to help non-profit and public-eligible healthcare providers fund telecommunication and information services necessary to provide critical care services.

DUE PROCESS & COMMERCE CLAUSES

To understand the limits on state taxation of any form of interstate commerce, including telehealth, we must start with the due process and commerce clauses in the U.S. Constitution:

1. The due process clause requires a minimum link or connection ("minimum contacts" nexus) between the taxpayer, state and transaction before a state may impose a tax. Since 1992 and the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota, 504 U.S. 298 (1992*), a taxpayer does not need to have a physical presence with a state for minimum contacts nexus under the due process clause. Instead, the taxpayer only needs purposefully directed economic activity at a state's market or consumers.

2. The commerce clause refers to Article 1, Section 8, Clause 3 of the U.S. Constitution, which states that Congress has the power "to regulate commerce with foreign nations, and among the several states." The commerce clause allows Congress to regulate business and trade among the states and to ensure that the states do not apply regulations that are overly burdensome to conducting business and trade or that discriminate against interstate or foreign commerce. The U.S. Supreme Court, in *Complete Auto Transit Inc. vs Brady*, *430 U.S. 274 (1977),* also established what is known as the "dormant" commerce clause, which imposes limitations for state taxes under the commerce clause:
   - A state may impose a tax if the activity gives rise to "substantial nexus."
   - The tax must be "fairly apportioned" among the various states.
   - No tax can discriminate against interstate commerce.
   - The tax must be "fairly related to the services provided by the state."

Beginning with direct, mail-order marketing and then in the 1990s as the Internet, telecommunications (including deregulation around it) and other technological innovations advanced, traditional ways of doing business changed. With the advent of e-commerce and more cross-state sales happening online, the physical presence standard prevented states from asserting nexus over out-of-state taxpayers. Without being able to establish nexus, states had no basis to levy sales or income tax.

THE SUPREME COURT SETS A NEW STANDARD

As e-commerce grew, states were losing tax revenue. Remote sellers lacked a physical presence in the states that they were selling into, so the states couldn't collect a sales tax. Forcing residents to pay use tax on out-of-state purchases is difficult and administratively burdensome for a state to enforce.

In 2018, more than 20 years after e-commerce first established a foothold in the American economy, the Supreme Court again faced a familiar conundrum: How should nexus apply to state taxation when there is no physical presence?

The court had already sanctioned economic presence for purposes of the due process clause minimum contacts nexus requirement in *Quill*. In *South Dakota v. Wayfair, 138 U.S. 2080 (2018*), the Supreme Court decided that the physical presence test to determine substantial nexus under the commerce clause was outdated, and not required for a remote seller to collect a sales tax. Online retail sales total hundreds of billions of dollars per year and most remote sellers will not have a physical presence in a state in which they are selling. Because of this, the Supreme Court viewed physical presence as hindering a state's ability to collect sales tax and that "nexus is clearly sufficient based on both economic and virtual contacts." Economic nexus was enough of a connection for South Dakota to require a remote seller to collect a sales tax.

Although *Wayfair* involved sales and use tax collection, the court's decision is not limited to sales and use taxes and applies equally to income taxes or any other state tax. Further, even after *Quill*, states had relied on that decision to justify the use of economic presence nexus for corporate income tax purposes, and the U.S. Supreme Court refused to exercise its discretion to review any of the number of state court decisions sanctioning that practice. Thus, the *Wayfair* decision signaled the death of any physical presence requirement for state taxation.

STATE STATUTES

For state income taxes, even before the *Wayfair* decision, states had been asserting economic presence nexus. For example, certain states, including California and New York, had enacted so-called "factor presence" nexus statutes, which, among other things, asserted income tax nexus over out-of-state businesses that had a certain threshold level of sales sourced to the state. Although New York's sales threshold was $1 million, the typical threshold was $500,000, including for California (which was also inflation-adjusted). Other states enacted economic presence nexus statutes based only on making sales or delivering services to in-state residents or businesses, while other states simply authorized income tax nexus "to the extent permitted by the U.S. Constitution."

FEDERAL LAW

The federal government enacted a law known as "Public Law 86-272" in 1959. It protects an out-of-state business whose sole activity in a state is the solicitation of orders for sales of tangible personal property if those orders are accepted outside the state and filled by shipment or delivery from a location outside the state. This federal law is limited in that only protects sellers of tangible personal property from state taxes on or measured by net income. Because telehealth is a service, Public Law 86-272 does not apply to providers of it.

NEXUS & TELEHEALTH

Whether because of existing statutes, case law or the *Wayfair* decision, states likely feel emboldened to assert economic presence nexus for income tax purposes over a range of service providers, including telehealth.

In addition, another state income apportionment trend serves to source sales or services receipts to the location of the customer, and thus create the economic connection upon which economic presence nexus relies. Only a minority of states follow the traditional costs-of-performance method now. Costs-of-performance sourcing typically sources receipts from services to the location where the provider performs the services rather than the location where the provider delivers the services or where target customers receive the benefit of the services (in the case of telehealth, for example, in their home). If a physician provides telemedicine to a patient located in a market-based state, then, the fees associated with the services will be allocated to the patient's state, whereas a cost-of-performance standard will source the services receipts to the state in which the physician is based.

Three ways nexus may apply to the different telehealth modalities:

Store-and-forward (asynchronous) video conferencing may involve the transmission of x-rays to a radiologist and consultation. In terms of market-based standards, the service fee could be sourced where the patient is located, whereas a cost-of-performance standard could source the fee to the state where the radiologist is based. Even though this example is straightforward, the transmission and downloading of data may complicate the service. For instance, from a market-based sourcing perspective, some states may view this as an in-person service, as a professional service or as a service delivered to or through a customer by electronic means. Each could have a different sourcing result and, thus, nexus result.

Remote patient monitoring can prove to be particularly "sticky" for a physician. If the physician owns the equipment and software that is monitoring the patient, there would not only be economic nexus, but also physical presence nexus. With two factors directly involved, nexus becomes more established.

Mobile health (mHealth) tax issues are similar to other telehealth modalities. Providers should scrutinize market-based and cost-of-performance standards, along with equipment ownership and data-transmission.

To practice across state lines, physicians usually must be licensed in a state other than their resident state. States such as Texas may issue an out-of-state medical license limiting the telehealth procedures that can be provided. To facilitate the cross-state expansion of telehealth, states created the **Interstate Medical Licensure Compact**. The Compact is an agreement between more than 20 states aiming to streamline the process for physicians to obtain licensure to practice in multiple states. As more states join the Compact, physicians will be able to serve patients across state lines. This will only further complicate income tax nexus and receipts sourcing issues. Let's look at an example:

> Dr. Jones is licensed in State A, which sources revenue on the cost of the performance. Dr. Jones provides telehealth services to a patient in State B, which follows market-based sourcing. In this fact pattern, would the service revenue be allocated to both states, resulting in a 200% allocation of revenue? What if State A was a market-based state and State B was a cost-of-performance state? Would neither state receive revenue? Providers should ensure they have the proper means of tracking where patients are located and where the physician is providing the services.

NAVIGATING A PATCHWORK OF REGULATIONS

COVID-19 has made telehealth an integral part of our healthcare system. Once an obscure term, telehealth is now part of our everyday vernacular. A technology that was primarily used by patients in remote areas of the country and millennials is now used by all generations. Hospitals, physicians and providers see telehealth as way to provide healthcare efficiently and effectively, and ultimately, a vehicle for providing better care.

Government regulations are always playing catch up with technology. The current tax authority and its application to telehealth is a patchwork of Supreme Court cases, and state and local tax regulations. Further, the interstate practice of telehealth will become more complex as providers navigate the allocation of service revenue on either cost-of-performance or market-based standards.

People who know Healthcare, know BDO.

www.bdo.com/**healthcare**

If you have questions about your organization's telehealth strategy, and implications for state taxation, reach out:

SPIRO LEUNES
Tax Partner
Core Tax Services
The BDO Center for Healthcare Excellence & Innovation
732-734-3031 / sleunes@bdo.com

JIM WHITE
Tax Partner and National Tax Leader
The BDO Center for Healthcare Excellence & Innovation
904- 224-9775 / jwhite@bdo.com