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Health Care Bulletin

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IRS ISSUES GUIDANCE ON PHYSICIAN RECRUITMENT INCENTIVES

Physician recruitment arrangements by tax-exempt hospitals are subject to scrutiny by the Internal Revenue Service ("IRS") because they potentially violate the prohibitions against private inurement and private benefit found in Section 501(c)(3) of the Internal Revenue Code ("Code") and corresponding Treasury Regulations. Prior to now, little formal guidance existed to assist tax-exempt hospitals seeking to attract new physicians with recruitment incentives. While Section 333.3 of the Audit Guidelines for Tax-Exempt Hospitals and the Hermann Hospital Recruitment Guidelines have served as useful predictors of how the IRS might evaluate certain physician incentive arrangements, until Revenue Ruling 97-21 ("Rev. Rul. 97-21"), no legally binding authority on the issue had been promulgated.

Rev. Rul. 97-21 Provides Precedential Authority

Rev. Rul. 97-21 provides the first legally binding guidance on how tax-exempt hospitals may incentivize physicians to join their staffs or to provide medical services to the community. Largely consistent with the proposed revenue ruling announced in 1995 ("Ann. 95-25"), Rev. Rul. 97-21 is generally viewed as favorable to hospitals in terms of allowing flexibility in recruitment arrangements that are well-documented and meet certain criteria. In delineating the range of permissible physician recruitment arrangements, Rev. Rul. 97-21 outlines the standards of review for such activities and applies that analysis to five specific fact situations.

In four of the five scenarios, the IRS determined that the hospitals did not violate the requirements of Section 501 (c)(3) of the Code because the physician recruitment activities: 1) furthered the hospital's charitable purposes; 2) did not result in inurement; 3) did not cause the

hospitals to serve a private, rather than public, purpose; and 4) were assumed to be lawful for purposes of the ruling. In addition, in each of the four acceptable scenarios, the arrangements were negotiated at arm's length and approved by the Hospital's board of directors ("Board"), a committee appointed by the Board to approve contracts with hospital medical staff, or the officer designated by the Board to enter into a contract. The agreements also were in accordance with the physician recruitment guidelines established and regularly reviewed by the hospital's Board, and the hospital did not provide any recruitment incentives other than those set forth in the written agreement. In the fifth scenario, however, the hospital was found to be in violation of the exemption requirements because its recruitment arrangement led to a criminal conviction under the federal anti-kickback laws.

In each of the scenarios described in Rev. Rul. 97-21, the hospitals have been recognized as tax-exempt and operate in accordance with the standards for exemption under the Code. Additionally, the physicians recruited are deemed not to have substantial influence over the affairs of the hospitals that are recruiting them, and therefore, are not disqualified persons as defined in Section 4958 of the Code. Nor do they have any personal or private interest in the activities of the organization that would subject them to the Section 501(c)(3) proscription on inurement.

Situation 1. A rural hospital located in a county designated as a Health Professional Shortage Area (HPSA) recruits an obstetrician/gynecologist to become a member of its staff and establish full-time practice in its service area. Under a written agreement negotiated at arm's length which meets the recruitment guidelines established by the hospital's Board, the hospital provides a recruitment package in which it agrees to pay the physician a signing bonus (of an unspecified amount), cover his professional liability insurance premium for a "limited period," provide office space at below market rent for a limited number of years, guarantee a mortgage on a home in the area, and provide start-up financial assistance pursuant to a properly documented loan agreement. In this scenario, the loan agreement bears "reasonable terms," which presumably include a commercially reasonable interest rate on the loan, as well as a reasonable repayment schedule. The agreement is approved by a committee appointed by the hospital's Board and authorized to approve contracts with medical staff members.

Situation 2. The hospital in this scenario is located in an economically depressed inner city neighborhood. Its community needs assessment indicates that a shortage of pediatricians in the service area exists and that Medicaid patients are having difficulty obtaining pediatric services. The hospital recruits a physician to relocate to the city, open a full-time pediatric practice in the hospital's service area, become a member of the hospital's medical staff and treat a reasonable number of Medicaid patients. Pursuant to a written agreement negotiated at arm's length and approved by the hospital's Board, the hospital reimburses the physician for "moving expenses" (as that term is defined in Section 217(b) of the Code), as well as his professional liability "tail" coverage for his former practice. The hospital also guarantees the physician's private practice net income for a limited number of years if the physician practices full time in the hospital's service area and does not generate a certain level of net income.

Situation 3. The hospital, located in an economically depressed inner city neighborhood, conducts a community needs assessment that indicates a shortage of obstetricians willing to treat indigent patients. The hospital enters into an agreement with an obstetrician who is already a member of the hospital's medical staff to treat a reasonable number of Medicaid and charity care patients for one year. The hospital in return agrees to reimburse the physician for that year's professional liability insurance premium. The agreement is in writing and is consistent with physician recruitment guidelines established by the hospital's Board. It is approved by the officer designated by the hospital's Board to enter contracts with medical staff members.

Situation 4. A hospital located in a medium-to-large metropolitan area requires a minimum of four diagnostic radiologists to ensure adequate coverage and quality care for its radiology department. Two of the four diagnostic radiologists are leaving, and the hospital institutes a search for two replacements. It determines that one of the qualified candidates is a physician who is on the staff of another hospital in the same city, at which hospital the physician provides radiology services for patients but does not refer any patients to that or any other hospital in the city. The hospital recruits the physician to join its medical staff and provide coverage for its radiology department. Under an agreement negotiated at arm's length and approved by the hospital's Board, the hospital guarantees

the physician's private practice net income for the first few years that the physician is a member of the hospital's medical staff and provides coverage for its radiology department.

Situation 5. A hospital in a medium-to-large city has engaged in physician recruitment activities that resulted in its being found guilty of knowingly and willfully violating the Medicare and Medicaid anti-kickback statute, 42 U.S.C.A. § 1320a-7b (1997). The conviction was based on recruitment incentives offered by the hospital which constituted payments for referrals.

Analysis

Rev. Rul. 97-21 states that in order to meet the requirements for maintaining tax-exempt status under Section 501(c)(3) of the Code, a hospital that provides recruitment incentives must do so in a manner that does not violate the "operational" test of Section 1.501(c)(3)-1 of the Treasury Regulations. Whether the operational test is met is determined based on all relevant facts and circumstances, including dollar amounts and duration of incentives.

A somewhat different analysis applies when a tax-exempt hospital recruits a physician for its medical staff to provide services to the surrounding community, but not necessarily on behalf of the organization. Rev. Rul. 97-21 outlines four basic criteria which must be met in these situations:

- *Furtherance of Exempt Purpose*. The hospital may not engage in substantial activities that do not further its exempt purposes. All recruitment activities must be reasonably related to the accomplishment of those purposes.

- *Inurement*. The hospital must not engage in activities that result in inurement of its net earnings to a private shareholder or individual.

- *Private Benefit*. The hospital may not engage in substantial activities that cause it to be operated for the benefit of a private rather than a public interest so that it has a substantial nonexempt purpose.

- *Legality*. The hospital may not engage in substantial unlawful activities.

Rev. Rul. 97-21 does not specifically state what factors the IRS will consider in deciding if the above criteria are met. One may discern from Rev. Rul. 97-21, however, that the following considerations will play an integral role in the IRS' future decisions in the area of physician recruitment by hospitals.

Demonstrated Community Need. In all four of the permitted scenarios, the hospitals presented objective evidence of a need for the recruited physicians' services, whether through a government study, designation as a HPSA or the hospital's own community needs assessment. In each situation, this objective showing of community need was a key factor in the IRS determination that the recruitment arrangements furthered the hospitals' charitable purposes, and that they were reasonable in light of the benefits derived by the hospital.

Documentation and Approval Criteria. In each scenario laid out in Rev. Rul. 97-21, the physician recruitment agreement was in writing, negotiated at arm's length, and approved by the hospital governing Board or by a committee or designated officer according to policy established and reviewed by the Board. The agreements are also in accordance with the physician recruitment guidelines established and regularly reviewed by the hospital's Board. In all four permitted situations, the hospital does not provide any recruitment incentives other than those set forth in the written agreement.

Recruitment Incentives. In Rev. Rul. 97-21, the IRS approved of a number of specific incentives in its ruling on the facts presented. Those incentives included: signing bonuses; payment of malpractice insurance premiums for a limited time period; subsidized office rent for a limited period; home mortgage guaranty; reimbursement of moving expenses; reimbursement of malpractice "tail" coverage; private practice net income guaranty for a limited time period; start-up financial assistance in the form of a loan that is properly documented and bears so-called "reasonable terms" (e.g., a commercially reasonable interest rate). Thus, the ruling suggests that hospitals may utilize a variety of incentives to attract needed providers to the area.

The ruling does not claim to be an exclusive list of permitted incentives, or that these incentives will be appropriate in every fact situation. Nor does it necessarily

imply that the incentives may be unlimited in duration or amount. Rather, the IRS has indicated that the ruling is intended as general guidance on physician recruitment arrangements and that the reasonableness of a particular arrangement, including dollar amounts and durations of incentives, would depend on all relevant facts and circumstances.

Cross-Town and Staff Physician Recruitment. Rev. Rul. 97-21 distinguishes between physicians who are recruited from outside the hospital's service area, those who are already on the hospital's staff, and physicians on the staff of another local area hospital. This differentiation could be read to imply that more relaxed standards might apply to incentives offered to physicians already on staff as in Situation 3, and to "cross-town" recruitment incentives provided to physicians who already practice at other institutions in the hospital's service area, as in Situation 4.

Income Guarantees. The use of salary surveys is permitted as a means to support the reasonableness of the net income guarantees in Rev. Rul. 97-21. For example, under the private practice income guarantees used in Situations 2 and 4, the ruling notes that the amount of the net income guarantee fell "within the range reflected in regional or national surveys regarding incomes earned by physicians in the same specialty."

Undue Influence. Rev. Rul. 97-21 states that the physicians involved in the first four Situations "do not have substantial influence over the affairs of the hospitals that are recruiting them." Accordingly, under Rev. Rul. 97-21, these physicians would not be "disqualified persons" (as that term is defined in Section 4958(f)(1) of the Code), nor do these physicians have any personal or private interest in the activities of the hospitals that would subject them to the inurement proscription of Section 501 (c)(3) of the Code. This applies even to Situation 3, where the physician was already on staff at the recruiting hospital and therefore would have been considered an insider based on prior guidance from the IRS.

Practical Application of Rev. Rul. 97-21

Although Rev. Rul. 97-21 is precedential authority, health care organizations must exercise care in their reliance on the IRS' latest pronouncement on physician recruitment agreements. Health care entities other than hospitals rely

implementation of strategic initiatives by health care entities, such as primary care satellite programs, physician recruitment and retention initiatives, and program development in emerging areas such as home health and outpatient mental health;

- Tax-exempt and taxable financing (both as borrowers' and underwriters' counsel); and
- Development of innovative responses to Medicaid and other publicly sponsored managed care initiatives.

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on Rev. Rul. 97-21 at their peril. For that matter, even hospitals should view Rev. Rul. 97-21 with circumspection. To the extent practical, hospitals seeking to rely on Rev. Rul. 97-21 should evidence circumstances substantially similar to one of the first four factual situations discussed above.

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