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IRS PROPOSES RULING ON PHYSICIAN RECRUITMENT

How a Hospital Recruits Physicians Would Affect Its Tax-exempt Status

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For the past 10 years, not-for-profit hospitals have had virtually no legally binding guidance to rely on in determining how physician recruitment could affect their tax-exempt status. But on March 15, 1995, the Internal Revenue Service (IRS) announced a proposed revenue ruling stating how certain physician recruitment practices could be implemented without threatening hospitals' exemption.¹ In many respects, the ruling's analysis reflects guidance found in earlier nonbinding IRS releases. Although the ruling may leave many questions unanswered, it does provide some helpful guidance for tax-exempt hospitals.

THE RULING'S IMPORTANCE

The ruling would be the first legally binding guidance for tax-exempt organizations issued by the IRS since 1986. As proposed, it would provide flexibility for recruitment incentives rather than a list of strict physician recruitment guidelines. The proposed ruling is not legally binding

until issued in final form, and there is no deadline for finalizing it. In the meantime, however, the standards outlined in the proposed ruling reflect arrangements the IRS likely would approve, which should be an incentive for tax-exempt hospitals to follow reasonable physician recruitment practices.

STANDARDS OF IRS REVIEW

The proposed ruling addresses standards for review of recruitment arrangements generally and as applied to five specific fact situations (discussed in the next section). The four basic standards for analyzing physician recruitment incentives, drawn from earlier IRS guidance in related legal areas,² are as follows:

- A reasonable relationship must exist between the incentive and furtherance of exempt purposes (including anticipated community benefits).
- There must be no inurement of net earnings.
- Primarily public benefit must result from the incentives and no more than incidental private benefit to physicians.

Summary On March 15, 1995, the Internal Revenue Service (IRS) announced a proposed revenue ruling stating how certain physician recruitment practices could be implemented without threatening hospitals' tax-exemption.

As proposed, the IRS ruling would provide flexibility for recruitment incentives rather than a list of strict physician recruitment guidelines. The proposed ruling is not legally binding until issued in final form, and there is no deadline for finalizing it. In the meantime, however, the standards outlined in the proposed ruling reflect arrangements the IRS likely would approve, which should be an incentive for tax-exempt hospitals to follow reasonable physician recruitment practices.

Assuming a hospital complies with other legal requirements such as fraud and abuse laws, it must answer two key tax-exempt status questions for its recruitment or retention package:

- Will the incentives result in a disguised distribution of profits from the operation of the organization?
- Is the total incentive package reasonable under all the facts and circumstances, both in absolute total value for physician(s) recruited and in relation to services required by the hospital and the community?

The proposed ruling also provides guidance on basic documentation requirements and a process for approving recruitment arrangements.

• The incentives must be legal.

INCENTIVES ADDRESSED

The proposed ruling discusses five hypothetical situations that cover hospitals in rural areas, economically depressed urban areas, and major metropolitan areas. The situations involve a new physician, a relocating physician, malpractice coverage for treating a reasonable number of indigent patients, cross-town recruitment, and fraud and abuse violations. Each of the situations relates to recruitment of staff physicians, not employment or practice acquisitions. Of these hypothetical situations, four result in no inurement or excess private benefit. Only the example of substantial and willful fraud and abuse violations would result in loss of exemption. The **Box** describes the incentives approved in the proposed ruling.

FLEXIBILITY IN RECRUITMENT

The ruling uses a flexible "reasonableness" standard rather than a "safe harbor" approach, which would provide an all-inclusive list of permitted and prohibited incentives. The variety of incentives addressed in the proposed ruling indicates that the critical issue is the reasonableness of the total incentive package, not whether the IRS has favorably reviewed a particular incentive.³ Certain incentives, such as ones resembling corporate stock dividends from the hospital, may be deemed abusive as distributions of net revenues of the exempt organizations.⁴ Absent such practices, however, a hospital should review an incentive package based on its reasonableness in the aggregate. In this context, the hospital must measure reasonableness both in terms of the total amount or value of incentives and in terms of the incentives' use as a means to obtain services for the hospital and its community.

The ruling states that the IRS will approve crosstown recruitment arrangements that help meet a demonstrated programmatic need at the hospital (thus resulting in a significant community benefit). The ruling also introduces the possibility of more flexibility in income guaranties by removing any absolute requirement of a cap on hospital payments, mandatory repayment, or

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particular packages of incentives, may affect the conclusion on exemption. Nevertheless, it is unlikely the IRS would revoke a hospital's tax-exempt status based simply on the mixing and matching of these incentives. The total incentive package, however, must be reasonable in amount and bear a reasonable relationship (as determined by the hospital board or designees) to the hospital's exempt purposes, such as meeting a documented community need for specific physician services.

PROCEDURES AND DOCUMENTATION

The proposed ruling also provides guidance on basic documentation requirements and a process for approving recruitment arrangements. Each recruitment arrangement should be:

- Set forth in a written agreement

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community service, at least pending clarification of what terms the IRS considers "commercially reasonable."

The proposed ruling does not address the full spectrum of prohibited and permitted incentives, nor all conditions under which the listed incentives would be permitted or prohibited for tax-exempt hospitals generally. The IRS notes that any change in fact patterns, including the

APPROVED INCENTIVES

The proposed revenue ruling approves situations in which hospitals:

- Pay physicians a \$5,000 signing bonus
- Pay physicians' malpractice insurance premium for one year
- Provide physicians subsidized office rent for three years
- Provide physicians guarantee of a home loan
- Pay financial assistance on "commercially reasonable terms" to physicians for practice start-up
- Reimburse physicians for moving expenses
- Reimburse physicians for malpractice "tail" coverage
- Provide physicians a three-year private practice net income guarantee at an amount within the range of national or regional salary surveys, after reasonable expenses of the practice and on "commercially reasonable terms" (which the IRS has yet to clarify)

TRANSFORMATION

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The congregation continues to sponsor the hospital.

has also agreed to guarantee St. Vincent's debt.

The congregation selected MHS largely because the multispecialty group practice in Taylorville (13 of 16 physicians) had also aligned with MHS. Now both the hospital and this physician group come under the MHS umbrella. The improved planning and strategic integration of the hospital and physician clinic will better serve the community's healthcare needs.


St. Clement Hospital and MariaCare Nursing Home Currently discussions are under way with a Catholic system in St. Louis about some arrangement with these two facilities.

SUCCESSFUL TRANSITION

These arrangements have achieved the following goals:

- Successful transition of the ASC healthcare facilities into stronger, regionally based systems that share compatible values and provide a better long-term future for each facility and for the quality of healthcare in their service areas

- Retention of the ASC congregation's canonical sponsorship of three facilities, while the operational and fiscal responsibility, as well as significant control, is transferred to other regional healthcare systems □

 For more information, call Gregory F. Yank at 618-628-1311 or the ASC Health Services office at 618-632-1284.

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- Negotiated at arm's length
- Approved by the hospital governing board or its designees
- Limited so that all incentives provided are described in the agreement (i.e., no "off-agreement" incentives provided)
- Supported by documented community need and community benefit, with a higher degree of community benefit required for crosstown recruitment

To help ensure compliance with IRS standards, tax-exempt hospitals should have clearly established and enforced policies and procedures for board approval (or appropriate delegation) of all recruitment agreements and programs.

The ruling illustrates that documentation of community need/benefit and of the reasonableness of incentives is critical to any recruitment program. Examples of such documentation are⁵:

- Designation as a health professional shortage area
- Community needs assessment by the hospital
- Steps to ensure access and high quality or reduce costs in existing programs

The proposed ruling would also permit reliance on regional or national salary surveys as one means to support the reasonableness of net income guarantee levels. Nevertheless, salary surveys not specifically tailored to the particular physician and community may be insufficient in some circumstances, such as outliers at the high end of a range or with significant fringe benefits. More specific salary surveys involving competitors, however, may raise antitrust issues. For outliers it may be appropriate to retain an independent compensation consultant or at least document the physician's exceptional qualifications.


PROTECTION OF TAX-EXEMPT STATUS

Assuming a hospital complies with other legal requirements such as the

fraud and abuse laws, it must answer two key tax-exempt status questions for its recruitment or retention package:

- Will the incentives result in a disguised distribution of profits from the operation of the organization?
- Is the total incentive package reasonable under all the facts and circumstances, both in absolute total value for the physician(s) recruited and in relation to services required by the hospital and the community?

Although the proposed ruling does not discuss retention incentives, the IRS has solicited comments on them. In the meantime, such incentives should be structured to comply with the recruitment guidelines, perhaps with additional support by a demonstrated community need or benefit. Finally, even if an incentive meets IRS standards, restrictions under the Stark Law and fraud and abuse laws must be considered. Arrangements that may be more of a concern under those laws include retention agreements, crosstown recruitment, and recruitment to urban areas. □

 For more information, call Gerald M. Griffith at 313-256-7630.

NOTES

1. Announcement 95-25, 1995-14 Internal Revenue Bulletin 10.
2. Gerald M. Griffith, A+ *Monograph Series*, "Physician Recruitment and Retention: Reconciling Legal Tensions between Tax Law and Fraud and Abuse," National Health Lawyers Association, Washington, DC, 1995.
3. Griffith, A+ *Monograph Series*.
4. See, for example, General Counsel Memorandum 39862, November 21, 1991.
5. For discussions of community benefit and community need, see Gerald M. Griffith, "Community Benefits of PHO and MSO Participation," *Journal of Health and Hospital Law*, May-June 1995, p. 129; Griffith, A+ *Monograph Series*, pp. 46-47.