An Internal Revenue Service ("IRS") Private Letter Ruling ("the Ruling") recently made available provides useful guidance to tax-exempt hospitals on permissible recruitment incentives that can be extended to new physicians entering private practice, and to physicians who may already be practicing in the community (i.e., "cross-town" recruiting). It also provides some practical perspectives on internal hospital procedures that should be followed in order to confirm that the recruitment activity is consistent with the hospital’s exempt purposes (e.g., maintaining “up-to-date” community need assessments; the use of surveys to document reasonableness of incentives; and board or committee approval and oversight of the proposed recruitment incentives). As such, the Ruling is the first practical application of Revenue Ruling 97-21, the IRS’s formal statement on the consequences of physician recruitment activities by tax-exempt hospitals. Furthermore, the Ruling represents a noteworthy expansion on some of the concepts set forth in the IRS’s 1994 closing agreement with Hermann Hospital, of Houston, particularly with respect to the extent of recruitment costs that can be absorbed by a tax-exempt hospital.

While helpful, the Ruling should not be interpreted as providing carte blanche authority for the extension of incentives in connection with “cross-town recruiting”. The recruitment activity aimed at existing practitioners in this Ruling is extremely limited to physicians in practice for only a few years and whose practice is not well developed. Furthermore, there may be substantial additional restrictions on cross-town recruiting under the Stark II and Fraud and Abuse laws that may be applicable in a given scenario.

1. Background Information

The subject hospital is a tertiary care facility located in an urban/suburban setting, which has worked to develop a geographically diverse integrated health care delivery and financing system. A specific strategic focus of the hospital in recent years has been the development of a series of community health centers ("Centers"), providing specialized non-tertiary inpatient and outpatient services. Designed to provide access to the hospital’s services to a larger number of community residents, the Centers are located in growing areas of the hospital’s service area where there is a need for additional primary care and specialist physicians. The Centers are being developed in conjunction with a primary care physician group loosely affiliated (i.e., not owned or controlled by) the hospital ("the Group").

The hospital’s most recent community needs assessment determined that in order to address a shortage of primary care physicians and certain
physician specialists, additional physicians must be recruited to join the Group and to provide care in the communities served by the Centers. While the hospital has historically provided certain physician recruitment incentives as approved by its Board, it sought to broaden the scope of its recruitment activities to respond fully to the need for additional physicians in the community and to the recruitment activities of its competitors (and submitted the Ruling request to seek approval of the new recruitment activities).

2. **The Recruited Physicians**

The hospital’s goal was to offer an expanded set of recruitment incentives in order to support the recruitment of primary care physicians and other under-represented specialists who are (i) new physicians and will be joining the Group or another established physician group; and (ii) physicians who have been practicing in the hospital’s service area for less than four years but have not established a “meaningful practice” at their current practice site and who have evidenced an interest in relocating to a practice site near one of the Centers.

3. **The Recruitment Incentives**

The specific new recruitment incentives to be offered by the hospital include the following:

(a) an income guarantee between the hospital and the recruited physician and, in the case of a new physician, the recruiting physicians;

(b) a signing bonus;

(c) reimbursement of reasonable relocation expenses;

(d) a one-time only marketing payment designed to cover the cost of distributing relocation announcements and issuing press releases; and

(e) for currently practicing physicians only, a financial incentive, loan or advance to enable the physician(s) to terminate any pre-existing office space lease obligations.

The hospital will not provide any “off agreement” incentives or benefits. The incentives are to be reflected in a physician recruitment agreement (“Recruitment Agreement”) negotiated between the hospital and the recruited physician and, in the case of a new physician, the recruiting physicians.

The income guarantee agreement contains a number of noteworthy provisions. First, it defines “direct and indirect costs” (for purposes of the economic calculation of the guaranteed amount) to include the following physician expenses: (a) malpractice insurance; (b) occupational licenses and fees, dues and subscriptions, travel expenses and tuition for one continuing professional education seminar per year; (c) life and disability insurance premiums; and (d) applicable office overhead expenses. Second, the guaranteed amount is represented to be objectively reasonable, falling within the range reflected in regional or national surveys regarding income earned by physicians in the same specialty. Third, the income guarantee will contain a “cap” or maximum financial obligation of the hospital. Fourth, the hospital will not be obligated to advance any amounts under the agreement in the event (i) the physician’s income for the relevant month exceeds the guaranteed amount; (ii) in the case of a new physician, the recruited physician’s employment agreement with the recruiting physician is terminated or the recruiting physician ceases or materially changes operations; or (iii) in the case of a currently practicing physician, the recruited physician ceases or materially changes operations.

The Recruitment Agreement also commits the recruited physician (and, in the case of a new physician, the recruiting physician) to a series of specific obligations, including (i) pursuit and maintenance of a full-time medical practice in the community for the period of the income guarantee plus three years; (ii) maintenance of appropriate licenses and certifications; (iii) maintenance of eligibility for certification and work towards certification in the physician’s specialty; (iv) maintenance of membership on the hospital’s medical staff; and (v) performance of certain specified medical staff and administrative duties.  

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3 These include complying with all staff rules and regulations; developing and maintaining dialogue with other staff members;
It is noteworthy that the Recruitment Agreement specifically refrains from restricting or preventing the recruited physician from establishing staff privileges or making referrals to other, non-affiliated, hospitals. Furthermore, the Agreement specifies that income guarantee advances do not obligate, and are not conditioned upon, the admission, recommendation, referral or other form of arrangement by the recruited physician (or, in the case of a new physician, the recruiting physician) for utilization by patients or others of any item or service ordered by the hospital or an affiliate.

Advances under the income guarantee will be treated as a loan by the hospital to (i) in the case of a new physician, the recruiting physicians; and (ii) in the case of a currently practicing physician, the recruited physician. Each loan will bear a market rate of interest, compounded monthly. The recruited or recruiting physician has a monthly repayment obligation on any balance due to the extent monthly income (exclusive of any bonus) exceeds the guaranteed amount.

As originally structured, each loan would be evidenced by (i) in the case of a currently practicing physician, a written promissory note reflecting the obligation of the recruited physician’s obligation to repay the loan; and (ii) in the case of a new physician, two written promissory notes (the “A” Note and the “B” Note), each of which reflect the obligation of the recruiting physician to repay one-half of the loan. Both of the notes to be used by the recruited physician require the recruited physician or the recruiting physician, as the case may be, to repay the hospital the balance due at the end of the guarantee period in equal monthly installments of principal and interest over the following 36 months. Again, as originally structured, the recruiting physician’s repayment obligation under the “A” Note is absolute, while the “B” Note may be satisfied by the recruited physician’s continued maintenance of a full-time medical practice in the community (i.e., for each month beyond the guarantee period that the physician maintains his/her practice, the balance due will be reduced by 1/36).

As part of its ruling request, and only with respect to new physicians, the hospital proposes to conform the repayment terms of the “A” Note to the “B” Note, so that the entire amount of the loan could be “worked down” by continued full-time practice in the community.

The hospital’s interest will be secured by an enforceable lien against all of the right, title and interest of the recruited and recruiting physicians in specific “hard assets” of the practice, as well as accounts receivable (other than Medicare/Medicaid receivables).

The Agreement contains standard termination rights in favor of the hospital, in which case the balance due would be repayable in 36 monthly installments.

4. The Rulings

The rulings requested by the hospital, and granted by the IRS, were two-fold: (a) that the hospital’s forgiveness of the entire amount of the advance to the new physicians pursuant to the terms of the A/B Notes would not jeopardize its exempt status; and (b) the income guarantee and other incentives extended to the currently practicing physicians will also not jeopardize the hospital’s exempt status (as long as the related payments do not violate the Medicare/Medicaid “Anti-Kickback” laws).

5. Analysis

This Ruling should be helpful to tax-exempt hospitals considering physician recruitment incentives designed to attract new physicians to medically underserved areas of their market.

Most notably, the Ruling offers a discrete expansion of one of the most widely referenced aspects of the “Hermann Hospital” closing agreement with the IRS. Section II-R of the Hermann “Hospital Physician Recruitment Guidelines” set forth thereunder provides that where a permissible recruit is recruited to enter an existing physician’s medical practice, the hospital can pay no more than 50 percent of the recruiting fees or costs associated with that physician. Yet, in the

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4 E.g., equipment, furnishings, and fixtures.
5 E.g., in the event of default or violation of law.
Ruling, the IRS approves the forgiveness of the entire amount owed under the Recruitment Agreement for new physicians as long as the subject physician maintains his/her full-time practice for the three-year period following the end of the income guarantee period. For hospitals that have heretofore been reluctant to depart from the scope/comfort of the Hermann guidelines, this could provide flexibility.

As such, the Ruling is a useful supplement to Revenue Ruling 97-21 and is consistent with its conclusions. Indeed, in the Ruling, the IRS approves of certain incentives—signing bonuses, relocation expenses, marketing fee and an advance to pay off existing space obligations—that were not specifically approved in Revenue Ruling 97-21, at least in the context of acceptable recruitment activities by a metropolitan hospital (i.e., “Scenario 4”). The marketing fee and space obligation payoff advance might be useful new incentives for hospitals to consider.

It is important to note, however, that the IRS’s favorable conclusion is based in large part on the charitable purpose served by recruiting physicians to a medically underserved area. The Ruling provides (at p. 13) that “[F]or the incentives to be offered by an organization to be consistent with its exempt purposes, objective evidence needs to be provided, in the form of a community needs assessment, demonstrating a need for physicians in the area”. Hence, a valuable lesson from the Ruling is the benefit that can be derived from maintaining a thorough, detailed community needs assessment that is regularly updated by the hospital.

Another useful lesson from the Ruling is the benefit arising from maintaining a formal corporate physician recruitment plan with related board/key committee approval and oversight of specific recruitment efforts. The Ruling is also helpful to the extent that it provides substantial detail on the parameters of an acceptable income guarantee agreement and related security provisions (including the importance of supporting guarantee levels with reference to national or regional physician income surveys). The Ruling also (indirectly) suggests that the recruitment efforts of competitors may possibly be a factor to which the IRS could refer in evaluating the reasonableness of a particular hospital’s recruitment efforts (as it is known to do with medical practice acquisitions). Hence, to the extent a hospital can appropriately obtain demonstrable evidence of such efforts, it may ultimately prove to be helpful.

There are, however, several substantial provisions of the Ruling which may limit its ultimate effectiveness, at least on an “across the board” perspective.

In particular, the Ruling should not be interpreted as generally authorizing the provision of “cross-town” recruiting incentives. The recruitment activity aimed at existing practitioners in the Ruling was extremely limited to physicians in practice in the community for less than four years, whose practice is “floundering” and thus do not have an established patient base. This is consistent with the approach taken in “Scenario 4” of Revenue Ruling 97-21, which approved of the cross-town recruitment only in the context of a radiologist who, by nature, was not in a position to make patient referrals to the hospital. Hence, it can be inferred from both the Ruling and Revenue Ruling 97-21 that the IRS has yet to evidence support for incentives for cross-town recruitment activities aimed at established physicians with a patient base, whose practice is not “floundering”. Fraud and Abuse compliance is, of course, a critical component of any appropriate physician recruitment incentive (see, e.g., references above on the absence in the Recruitment Agreement of any prohibition on the recruited physician’s ability to be on the staff of, or refer patients to, a non-affiliated hospital).

Furthermore, it should be noted that such cross-town recruitment activity is potentially inconsistent with the proposed regulations under Stark II, which require that a physician be recruited from outside a hospital’s geographic area to satisfy the “physician recruitment” exemption to Compensation Arrangements. However, the proposed regulations note that recruitment payments made to physicians who are living in the hospital’s “geographic area” (the cited example is to retain residents) or to a group practice that intends to employ the physician and contracts with the hospital, and

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6 It is also consistent with the Hermann Guidelines, in which the definition of “permissible recruit” did not include a physician practicing in its service area.
might be exempted under the proposed new fair market value exception for Compensation Arrangements.

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Hence, the Ruling is a useful addition to the “core” of resources (e.g., Rev. Rul. 97-21, Hermann) on tax-exempt issues associated with physician recruitment activity. It should not, however, serve as a “green light” for aggressive cross-town recruitment efforts.

For further information regarding this Ruling, or physician recruitment issues generally, please contact any member of the Gardner, Carton & Douglas Health Law Department.