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IRS continues to restrict hospital/physician relations

by John S. Hoff

Hospital arrangements with physicians are regulated by self-referral (fraud and abuse) legislation and, for not-for-profit hospitals, by the Internal Revenue Service's enforcement of the prohibition against transactions that constitute inurement or private benefit.

The physician recruitment and retention arrangements between Hermann Hospital in Houston, Texas, and its physicians jeopardized its tax-exempt status. The IRS did not revoke the hospital's exemption but required it to agree to a closing agreement. The agreement requires the hospital to pay the IRS approximately $1 million—the amount of taxes it would have had to pay if it had not been tax exempt (for one of the challenged years). The hospital also is required to report to the IRS the amounts it paid to physicians in incentive payments over the past four years (in all likelihood this will require the physicians to pay back taxes).

Of more general interest, the IRS required the hospital to agree to a detailed memorandum of strictures governing physician recruitment and retention practices (euphemistically called Physician Recruitment Guidelines). These guidelines are not unlike the NCAA rules on recruiting basketball players.

The IRS has recently said that the standards of the guidelines do not automatically apply to all hospitals and that different facts may produce different results in the particular case of other hospitals. Nevertheless, the guidelines are significant for hospitals and their physicians generally because they demonstrate IRS' attitude on this important and ambiguous issue.

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Some important provisions can be described.

1. A hospital may give incentives only to physicians who are "permissible recruits," meaning a physician who is a new graduate of a residency or fellowship program or who has not practiced in the hospital's community.

2. Even then, a recruitment incentive may be offered only if there is "a demonstrable community need for the physician." This need exists only if:

- the physician-population ratio in the community in the specialty at issue is below the ideal ratio as set by the Graduate Medical Education National Advisory Board.
- there is a documented lack of availability of the service at issue or a long waiting period for it
- the community has been designated as a Health Professional Shortage Area
- physicians are reluctant to relocate to the hospital because of its physical location (rural or economically disadvantaged inner city)
- the number of physicians in the relevant specialty in the community is expected to be reduced within the next three years
- there are not a sufficient number of physicians serving indigent or Medicaid patients (the new physician must commit to serve a substantial number of these patients)
- any incentives that are paid are not conditioned upon a requirement or understanding that the physician will admit or refer patients to the hospital.

3. The following are considered permissible incentives.

- Loans (including loan guarantees) are permitted if the loans are adequately secured and bear an interest rate that reflects market conditions. The loan may be forgiven only if the forgiveness is conditioned upon the physician's staying in the community.
- Reasonable income guarantees may be made (but not for more than two years).
- Subsidies may not be paid for overhead costs if the physician is receiving a loan or income guarantee.
- Hospitals may pay for interview travel expenses but may not pay signing bonuses.
- The hospital may not subsidize the compensation of the support staff or a nonemployee physician for his or her private practice.
- The hospital may not pay for or provide the physician's malpractice insurance for private practice. The hospital may provide malpractice insurance with respect to the physician's bona fide duties as medical director of the hospital or any other activity undertaken for and on behalf of the hospital that is distinct from his or her private practice. It cannot appoint a medical director unless there is a legitimate and demonstrable business purpose for doing so.
- The hospital may not provide subsidized parking, telephone, automobile, health insurance, dues, or licensing fees that relate to the physician's private practice.
- The hospital may not let the physician use its outpatient department for his or her private practice.

These provisions are no surprise; they are similar to but more specific than what the IRS announced in its "Audit Guidelines" in March 1992, and "General Counsel Memorandum 39862" (November 22, 1991). The provisions continue the trend of making it more difficult for not-for-profit hospitals to compete.