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Health Law Alert

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IRS Ruling Questions Tax Treatment of Hospital Income From Physician Practices

In a Private Letter Ruling released on April 20, 2007, the Internal Revenue Service (the "IRS") determined that income generated by certain "controlled" or "friendly" professional corporations ("PCs") of a tax exempt hospital was unrelated business taxable income ("UBTI") to the hospital. This ruling has potential implications for all hospital or medical school faculty practice plans.

The IRS found that the tax exempt hospital parent was a controlling organization of the PCs, by virtue of its ability to replace the physician shareholders and related factors. However, it also noted that "[n]o patients of the six PCs are also patients of Hospital," an unusual circumstance for professional corporations controlled by Hospital-employed shareholders. In that context, it is perhaps not surprising that the IRS's ruling concluded that the PCs' provision of medical services to the PCs' own patients "does not have a substantial causal relationship to the achievement of Hospital's exempt purposes" and that "the PCs are conducting their activities on a larger scale than is reasonably necessary for the performance of Hospital's exempt functions." Based on this finding, the IRS determined that interest payments from the PCs to the hospital (a deductible business expense by the PCs) would be unrelated income to the hospital.

The ruling letter does not fully detail the operational relationship between the PCs and the hospital, and the specific facts of the arrangement here were likely quite relevant. Critically, the IRS did not believe that patients of the controlled PC were automatically patients of the hospital and, in fact, the IRS distinguished between hospital and PC patients.

In addition, the tax analysis applied by the IRS in this ruling is not clear. For example, the IRS did not explain why it did not treat the hospital as if it had earned the income directly (as it seems clear that all the economic benefit belonged to the hospital, not the physicians). Without knowing more, it is unclear whether the result would have been different under this approach. Thus, all exempt hospitals should be aware that medical practices that do not advance the hospital's mission by treating a substantial proportion of patients who otherwise overlap with the hospital (presumably patients discharged from the hospital or patients with chronic conditions who are followed by hospital physicians after or between hospital visits) or who otherwise present special circumstances (an underserved population) might create UBTI. Faculty practice plans often treat a far broader group of patients than the hospital they serve, and often these faculty practices contribute greatly to institutional revenue. Further development and IRS explanation may be required here.

This ruling echoes concerns raised by the Appellate Division in *Odrich v. Trustees of Columbia University,* 308 A.D.2d 405 (N.Y. App. Div. 1st Dep't 2003). In *Odrich,* the Appellate Division affirmed a decision that found that Columbia University could not "tax" the private practices of the plaintiffs, who had been on the employed faculty at Columbia's medical school while providing services on the Columbia campus, and who desired to maintain their faculty relationship, even though they would no longer be employed by or practicing at the medical school. The Court, citing the key decision, *Albany Medical Center v. McShane,* found that a requirement that the physicians pay a percentage of income in return for a faculty appointment effectively constituted illegal fee splitting: "where the physicians are no longer employees of respondent's university faculty practice corporation and respondent is no longer providing petitioners with salary, employee benefits, facility supplies, staff or malpractice insurance." The Court further noted that "there may be other financial arrangements upon which the medical school could properly condition any appointment of petitioners to its part-time faculty."

In the underlying Supreme Court decision, Judge Yates explained why *McShane* did not protect the relationship with the Odrich brothers. "In a case where the treating physician receives no salary or related benefits from the school, has not entered into an agreement to pool resources and share responsibility for patient care, and where the treatment arises out of an arrangement between private doctor and patient at a location completely divorced from the medical school or hospital there is no connective relationship which would justify extending *McShane* to permit fee splitting with the medical school or hospital. Simply invoking the 'medical school' as a protective cloak without justification for the protection ignores the policy and reasoning implicit in the *McShane* decision."

The implication of Odrich is that *McShane* (which permitted hospital and medical school employment of physicians) does not apply if the physician service and the activities of the hospital or medical school are largely unrelated. Obviously, as noted above, provision of services to underserved communities by tax exempt entities (through employed physicians) would certainly be deemed to be related. However, a Medicare and commercially oriented practice in the community that is not related to ongoing care that the hospital is providing or anticipates providing to the same patient population, and is not rendered at or proximate to the hospital and integral to its direct services to the community, may raise concerns under both *Odrich* and the recent IRS ruling.

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