



 IRS, Rev. Rul. 97-21, 1997-1 C.B. 121

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Department of the Treasury  
Internal Revenue Service  
Revenue Ruling

## REV. RUL. 97-21, 1997-1 C.B. 121

[26 CFR 1.501\(c\)\(3\)-1](#): Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

**Tax consequences of physician recruitment incentives provided by hospitals described in [section 501\(c\)\(3\) of the Code](#).** This ruling provides examples illustrating whether nonprofit hospitals that provide incentives to physicians to join their medical staffs or to provide medical services in the community violate the requirements for exemption as organizations described in [section 501\(c\)\(3\)](#) of the Code.

### Rev. Rul. 97-21

#### ISSUE

Whether, under the facts described below, a hospital violates the requirements for exemption from federal income tax as an organization described in Section [501\(c\)\(3\)](#) of the [Internal Revenue Code](#) when it provides incentives to recruit private practice physicians to join its medical staff or to provide medical services in the community.

#### FACTS

All of the hospitals in the situations described below have been recognized as exempt from federal income tax under Section [501\(a\)](#) as organizations described in Section [501\(c\)\(3\)](#) and operate in accordance with the standards for exemption set forth in [Revenue Ruling 69-545](#), 1969-2 C.B. 117. The physicians described in the following recruiting transactions do not have substantial influence over the affairs of the hospitals that are recruiting them. Therefore, they are not disqualified persons as defined in Section [4958](#), nor do they have any personal or private interest in the activities of the organizations that would subject them to the inurement proscription of Section [501\(c\)\(3\)](#). Furthermore, in Situations 1, 2, and 4, the physicians have no pre-existing relationship with the hospital or the members of its board. For purposes of this revenue ruling, the physician recruiting activities described in Situations 1, 2, 3, and 4 are assumed to be lawful. However, because the Internal Revenue Service does not have jurisdiction regarding whether the activities described in Situations 1, 2, 3, and 4 are lawful under the Medicare and Medicaid anti-kickback statute, [42 U.S.C. Section 1320a-7b\(b\)](#), taxpayers may not rely upon the facts or assumptions described in this ruling for purposes relating to that statute.

#### *Situation 1*

Hospital A is located in County V, a rural area, and is the only hospital within a 100 mile radius. County V has been designated by the U.S. Public Health Service as a Health Professional Shortage Area for primary medical care professionals (a category that includes obstetricians and gynecologists). Physician M recently completed an ob/gyn residency and is not on Hospital A's medical staff. Hospital A recruits Physician M to establish and maintain a full-time private ob/gyn practice in its service area

and become a member of its medical staff. Hospital A provides Physician M a recruitment incentive package pursuant to a written agreement negotiated at arm's-length. The agreement is in accordance with guidelines for physician recruitment that Hospital A's Board of Directors establishes, monitors, and reviews regularly to ensure that recruiting practices are consistent with Hospital A's exempt purposes. The agreement was approved by the committee appointed by Hospital A's Board of Directors to approve contracts with hospital medical staff. Hospital A does not provide any recruiting incentives to Physician M other than those set forth in the written agreement. In accordance with the agreement, Hospital A pays Physician M a signing bonus, Physician M's professional liability insurance premium for a limited period, provides office space in a building owned by Hospital A for a limited number of years at a below market rent (after which the rental will be at fair market value), and guarantees Physician M's mortgage on a residence in County V. Hospital A also lends Physician M practice start-up financial assistance pursuant to an agreement that is properly documented and bears reasonable terms.

### *Situation 2*

Hospital B is located in an economically depressed inner-city area of City W. Hospital B has conducted a community needs assessment that indicates both a shortage of pediatricians in Hospital B's service area and difficulties Medicaid patients are having obtaining pediatric services. Physician N is a pediatrician currently practicing outside of Hospital B's service area and is not on Hospital B's medical staff. Hospital B recruits Physician N to relocate to City W, establish and maintain a full-time pediatric practice in Hospital B's service area, become a member of Hospital B's medical staff, and treat a reasonable number of Medicaid patients. Hospital B offers Physician N a recruitment incentive package pursuant to a written agreement negotiated at arm's-length and approved by Hospital B's Board of Directors. Hospital B does not provide any recruiting incentives to Physician N other than those set forth in the written agreement.

Under the agreement, Hospital B reimburses Physician N for moving expenses as defined in Section [217\(b\)](#), reimburses Physician N for professional liability "tail" coverage for Physician N's former practice, and guarantees Physician N's private practice income for a limited number of years. The private practice income guarantee, which is properly documented, provides that Hospital B will make up the difference to the extent Physician N practices full-time in its service area and the private practice does not generate a certain level of net income (after reasonable expenses of the practice). The amount guaranteed falls within the range reflected in regional or national surveys regarding income earned by physicians in the same specialty.

### *Situation 3*

Hospital C is located in an economically depressed inner city area of City X. Hospital C has conducted a community needs assessment that indicates indigent patients are having difficulty getting access to care because of a shortage of obstetricians in Hospital C's service area willing to treat Medicaid and charity care patients. Hospital C recruits Physician O, an obstetrician who is currently a member of Hospital C's medical staff, to provide these services and enters into a written agreement with Physician O. The agreement is in accordance with guidelines for physician recruitment that Hospital C's Board of Directors establishes, monitors, and reviews regularly to ensure that recruiting practices are consistent with Hospital C's exempt purpose. The agreement was approved by the officer designated by Hospital C's Board of Directors to enter into contracts with hospital medical staff. Hospital C does not provide any recruiting incentives to Physician O other than those set forth in the written agreement. Pursuant

to the agreement, Hospital C agrees to reimburse Physician O for the cost of one year's professional liability insurance in return for an agreement by Physician O to treat a reasonable number of Medicaid and charity care patients for that year.

#### *Situation 4*

Hospital D is located in City Y, a medium to large size metropolitan area. Hospital D requires a minimum of four diagnostic radiologists to ensure adequate coverage and a high quality of care for its radiology department. Two of the four diagnostic radiologists currently providing coverage for Hospital D are relocating to other areas. Hospital D initiates a search for diagnostic radiologists and determines that one of the two most qualified candidates is Physician P.

Physician P currently is practicing in City Y as a member of the medical staff of Hospital E (which is also located in City Y). As a diagnostic radiologist, Physician P provides services for patients receiving care at Hospital E, but does not refer patients to Hospital E or any other hospital in City Y. Physician P is not on Hospital D's medical staff. Hospital D recruits Physician P to join its medical staff and to provide coverage for its radiology department. Hospital D offers Physician P a recruitment incentive package pursuant to a written agreement, negotiated at arm's-length and approved by Hospital D's Board of Directors. Hospital D does not provide any recruiting incentives to Physician P other than those set forth in the written agreement.

Pursuant to the agreement, Hospital D guarantees Physician P's private practice income for the first few years that Physician P is a member of its medical staff and provides coverage for its radiology department. The private practice income guarantee, which is properly documented, provides that Hospital D will make up the difference to Physician P to the extent the private practice does not generate a certain level of net income (after reasonable expenses of the practice). The net income amount guaranteed falls within the range reflected in regional or national surveys regarding income earned by physicians in the same specialty.

#### *Situation 5*

Hospital F is located in City Z, a medium to large size metropolitan area. Because of its physician recruitment practices, Hospital F has been found guilty in a court of law of knowingly and willfully violating the Medicare and Medicaid anti-kickback statute, [42 U.S.C. Section 1320a-7b \(b\)](#), for providing recruitment incentives that constituted payments for referrals. The activities resulting in the violations were substantial.

## **LAW**

Section [501\(c\)\(3\)](#) provides, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable, scientific, or educational purposes, provided no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section [1.501\(c\)\(3\)-1\(d\)\(2\)](#) of the Income Tax Regulations provides that the term "charitable" is used in Section [501\(c\)\(3\)](#) in its generally accepted legal sense. The promotion of health has long been recognized as a charitable purpose. See *Restatement (Second) of Trusts*, Sections [368](#), [372](#) (1959); 4A Austin W. Scott and William F. Fratcher, *The Law of Trusts* Sections [368](#), [372](#) (4th ed. 1989); and Rev. Rul. [69-545](#), 1969-2 C.B. 117. Under the common law of charitable trusts, all such organizations are subject to the requirement that their purposes may not be illegal. See *Restatement (Second) of Trusts* Section [377](#) (1959); 4A Austin W. Scott and William F. Fratcher, *The Law of Trusts* Section [377](#)

(4th ed. 1989); *Bob Jones University v. U.S.*, [461 U.S. 574](#), 591 (1983); Rev. Rul. [80-278](#), 1980-2 C.B. 175; Rev. Rul. [80-279](#), 1980-2 C.B. 176.

Section [1.501\(c\)\(3\)-1\(c\)\(2\)](#) states that an organization is not operated exclusively for charitable purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section [1.501\(a\)-1\(c\)](#) defines “private shareholder or individual” as referring to persons having a personal and private interest in the activities of the organization.

Section [1.501\(c\)\(3\)-1\(d\)\(1\)\(ii\)](#) states that an organization is not organized exclusively for any of the purposes specified in Section [501\(c\)\(3\)](#) unless it serves public, rather than private interests. Thus, an organization applying for tax exemption under Section [501\(c\)\(3\)](#) must establish that it is not organized or operated for the benefit of private interests.

Rev. Rul. [69-545](#), 1969-2 C.B. 117, holds that a non-profit hospital that benefits a broad cross section of its community by having an open medical staff and a board of trustees broadly representative of the community, operating a full-time emergency room open to all regardless of ability to pay, and otherwise admitting all patients able to pay (either themselves, or through third party payers such as private health insurance or government programs such as Medicare) may qualify as an organization described in Section [501\(c\)\(3\)](#). The same standard has been used by the courts as the basis for evaluating whether health maintenance organizations qualify for exemption as organizations described in Section [501\(c\)\(3\)](#). *Sound Health Association v. Commissioner*, [71 T.C. 158](#) (1978), *acq.* 1981-2 C.B. 2; *Geisinger Health Plan v. Commissioner*, [985 F.2d 1210](#) (3rd Cir. 1993), *rev'g* [62 T.C.M. \(CCH\) 1656](#) (1991).

Rev. Rul. [72-559](#), 1972-2 C.B. 247, holds that an organization that provides subsidies to recent law school graduates during the first three years of their practice to enable them to establish legal practices in economically depressed communities that have a shortage of available legal services and to provide free legal service to needy members of the community may qualify as an organization described in Section [501\(c\)\(3\)](#).

Rev. Rul. [73-313](#), 1973-2 C.B. 174, holds that attracting a physician to a community that had no available medical services furthered the charitable purpose of promoting the health of the community. In Rev. Rul. [73-313](#), residents of an isolated rural community had to travel a considerable distance to obtain care. Faced with the total lack of local services, the community formed an organization to raise funds and build a medical office building to attract a doctor to the locality. (No hospitals or existing medical practices were involved.) The ruling states that certain facts are particularly relevant: (1) the demonstrated need for a physician to avert a real and substantial threat to the community; (2) evidence that the lack of a suitable office had impeded efforts to attract a physician; (3) the arrangements were completely at arm's-length; and (4) there was no relationship between any person connected with the organization and the recruited physician. The ruling states that, under all the circumstances, the arrangement used to induce the doctor to locate a practice in the area “bear[s] a reasonable relationship to promotion and protection of the health of the community” and any private benefit to the physician is incidental to the public purpose achieved. It concludes that the activity furthers a charitable purpose and the organization qualifies for exemption as an organization described in Section [501\(c\)\(3\)](#).

Rev. Rul. [75-384](#), 1975-2 C.B. 204, holds that an organization whose primary activity is sponsoring

antiwar protest demonstrations in which demonstrators are urged to commit violations of local ordinances and breaches of the public order does not qualify as an organization described in Section [501\(c\)\(3\)](#) because its activities demonstrate an illegal purpose that is inconsistent with charitable purposes.

Rev. Rul. [80-278](#) , 1980-2 C.B. 175, and Rev. Rul. [80-279](#) , 1980-2 C.B. 176, discuss the qualification as organizations described in Section [501\(c\)\(3\)](#) of organizations that conduct environmental litigation and environmental dispute mediation. In holding that these organizations may qualify, the rulings state that, in determining whether an organization meets the operational test, the issue is whether the particular activity undertaken by the organization appropriately furthers the organization's exempt purpose. The rulings state that an organization's activities will be considered permissible under Section [501\(c\)\(3\)](#) if the following conditions are met: (1) the purpose of the organization is charitable; (2) the activities are not illegal, contrary to a clearly defined and established public policy, or in conflict with express statutory restrictions; and (3) the activities are in furtherance of the organization's exempt purpose and are reasonably related to the accomplishment of that purpose.

## ANALYSIS

In order to meet the requirements of Section [501\(c\)\(3\)](#) , a hospital that provides recruitment incentives to physicians must provide those incentives in a manner that does not cause the organization to violate the operational test of Section [1.501\(c\)\(3\)-1](#) . Whether the recruitment incentives cause the organization to violate the operational test is determined based on all relevant facts and circumstances. When a Section [501\(c\)\(3\)](#) hospital recruits a physician for its medical staff who is to perform services for or on behalf of the organization, the organization meets the operational test by showing that, taking into account all of the benefits provided the physician by the organization, the organization is paying reasonable compensation for the services the physician is providing in return. A somewhat different analysis must be applied when a Section [501\(c\)\(3\)](#) hospital recruits a physician for its medical staff to provide services to members of the surrounding community but not necessarily for or on behalf of the organization. In these cases, a violation will result from a failure to comply with any of the following four requirements:

First, the organization may not engage in substantial activities that do not further the hospital's exempt purposes or that do not bear a reasonable relationship to the accomplishment of those purposes. As discussed in Rev. Rul. [80-278](#) and Rev. Rul. [80-279](#) , in determining whether an organization meets the operational test, the issue is whether the particular activity undertaken by the organization is appropriately in furtherance of the organization's exempt purpose.

Second, the organization must not engage in activities that result in inurement of the hospital's net earnings to a private shareholder or individual. An activity may result in inurement if it is structured as a device to distribute the net earnings of the hospital. See *Lorain Avenue Clinic v. Commissioner*, [31 T.C. 141](#) (1958); (Registered) *Birmingham Business College v. Commissioner*, *Birmingham Business College, Inc. v. Commissioner*, [276 F.2d 476](#) (5th Cir. 1960).

Third, the organization may not engage in substantial activities that cause the hospital to be operated for the benefit of a private interest rather than public interest so that it has a substantial non-exempt purpose. Section [1.501\(c\)\(3\)-1\(d\)\(1\)\(ii\)](#) .

Finally, the organization may not engage in substantial unlawful activities. As discussed in Rev. Rul. [75-384](#) , Rev. Rul. [80-278](#) , and Rev. Rul. [80-279](#) , the conduct of an unlawful activity is inconsistent

with charitable purposes. An organization conducts an activity that is unlawful, and therefore not in furtherance of a charitable purpose, if the organization's property is to be used for an objective that is in violation of the criminal law. Activities can accomplish an unlawful purpose through either direct or indirect means.

#### *Situation 1*

Like the organization described in Rev. Rul. [73-313](#) , Hospital A has objective evidence demonstrating a need for obstetricians and gynecologists in its service area and has engaged in physician recruitment activity bearing a reasonable relationship to promoting and protecting the health of the community in accordance with Rev. Rul. [69-545](#) . As with the subsidies provided to the recent law school graduates in Rev. Rul. [72-559](#) , the payment of a bonus, the guarantee of a mortgage, the reimbursement of professional liability insurance and provision of subsidized office space for a limited time, and the lending of start-up financial assistance as recruitment incentives are reasonably related to causing Physician M to become a member of Hospital A's medical staff and to establish and maintain a full-time private ob/gyn practice in Hospital A's service area. The provision of the incentives under the circumstances described furthers the charitable purposes served by the hospital and is consistent with the requirements for exemption as an organization described in Section [501\(c\)\(3\)](#) .

#### *Situation 2*

Like Hospital A in Situation 1, Hospital B has objective evidence demonstrating a need for pediatricians in its service area and has engaged in physician recruitment activity bearing a reasonable relationship to promoting and protecting the health of the community in much the same manner as the organization described in Rev. Rul. [73-313](#) . As with the recruitment incentive package provided by Hospital A, the payment of moving expenses, the reimbursement of professional liability "tail" coverage, and the provision of a reasonable private practice income guarantee as recruitment incentives are reasonably related to causing Physician N to become a member of Hospital B's medical staff and to establish and maintain a full-time private pediatric practice in Hospital B's service area. Thus, the recruitment activity described furthers the charitable purposes served by the hospital and is consistent with the requirements for exemption as an organization described in Section [501\(c\)\(3\)](#) .

#### *Situation 3*

In accordance with the standards for exemption set forth in Rev. Rul. [69-545](#) , Hospital C admits and treats Medicaid patients on a non-discriminatory basis. Hospital C has identified a shortage of obstetricians willing to treat Medicaid patients. The payment of Physician O's professional liability insurance premiums in return for Physician O's agreement to treat a reasonable number of Medicaid and charity care patients is reasonably related to the accomplishment of Hospital C's exempt purposes. Because the amount paid by Hospital C is reasonable and any private benefit to Physician O is outweighed by the public purpose served by the agreement, the recruitment activity described is consistent with the requirements for exemption as an organization described in Section [501\(c\)\(3\)](#) .

#### *Situation 4*

Hospital D has objective evidence demonstrating a need for diagnostic radiologists to provide coverage for its radiology department so that it can promote the health of the community. The provision of a reasonable private practice income guarantee as a recruitment incentive that is conditioned upon Physician P obtaining medical staff privileges and providing coverage for the

radiology department is reasonably related to the accomplishment of the charitable purposes served by the hospital. A significant fact in determining that the community benefit provided by the activity outweighs the private benefit provided to Physician P is the determination by the Board of Directors of Hospital D that it needs additional diagnostic radiologists to provide adequate coverage and to ensure a high quality of medical care. The recruitment activity described is consistent with the requirements for exemption as an organization described in Section [501\(c\)\(3\)](#).

#### *Situation 5*

Hospital F has engaged in physician recruiting practices resulting in a criminal conviction. As in Rev. Rul. [75-384](#), the recruiting activities were intentional and criminal, not isolated or inadvertent violations of a regulatory statute. An organization that engages in substantial unlawful activities, including activities involving the use of the organization's property for an objective that is in violation of criminal law, does not qualify as an organization described in Section [501\(c\)\(3\)](#). Because Hospital F has knowingly and willfully conducted substantial activities that are inconsistent with charitable purposes, it does not comply with the requirements of [Section 501\(c\)\(3\)](#) and [Section 1.501\(c\)\(3\)-1](#).

#### **HOLDING**

The hospitals in Situations 1, 2, 3, and 4 have not violated the requirements for exemption from federal income tax as organizations described in Section [501\(c\)\(3\)](#) as a result of the physician recruitment incentive agreements they have made because the transactions further charitable purposes, do not result in inurement, do not result in the hospitals serving a private rather than a public purpose, and are assumed to be lawful for purposes of this revenue ruling.

Hospital F in Situation 5 does not qualify as an organization described in Section [501\(c\)\(3\)](#) because its unlawful physician recruitment activities are inconsistent with charitable purposes.

#### **SCOPE**

This ruling addresses only issues under Section [501\(c\)\(3\)](#) in the described situations. No inference is intended as to any other issue under any other provision of law, including any issue involving worker classification, income tax consequences to the physicians, and application of the Medicare and Medicaid anti-kickback statute, [42 U.S.C. Section 1320a-7b\(b\)](#).

#### **DRAFTING INFORMATION**

The principal author of this revenue ruling is Judith E. Kindell of the Exempt Organizations Division. For further information regarding this revenue ruling contact Judith E. Kindell on (202) 622-6494 (not a toll-free call).

#### **Annotation**

Section [501](#) .--Exemption From Tax on Corporations, Certain Trusts, Etc.