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Physician Services Agreements Subject to Private Business Use Test

Non-profit healthcare providers who have borrowed the proceeds of tax-exempt bonds to pay for their facilities need to evaluate annually the professional service agreements they have with physicians to ensure that the agreements will not cause the bonds to fail the private business use test. Assessments of private business use are now a feature of the annual IRS Form 990.

An IRS private letter ruling released on June 26, 2009 helps clarify the facts and circumstances important to the IRS in determining whether an agreement with a physician or physician group performing professional services on the provider's property generates reportable private business use.

501(c)(3) organizations can typically direct only up to three percent of bond proceeds to private use (assuming costs of bond issuance were paid with bond proceeds) without compromising the tax-exempt status of the bonds. Depending on the terms of the contract, use of a bond-financed facility by physician contractors may be treated as the direct use of bond proceeds, and must be taken into account against this limitation.

The IRS has provided "safe harbor" guidelines for contracts with physicians and others who use health care facilities to earn income. To anchor a contract within a safe harbor, the provider must ensure that the physician's compensation is not based, in whole or in part, on a share of net profits from the operation of the health care facility. The June 26 private letter ruling gives the IRS's blessing to a physician contract that does not meet the standard safe harbor provisions, but nevertheless, under the facts and circumstances, provides for reasonable compensation for services, with no compensation based on a share of net profits.

The IRS focused on the compensation structure set forth in the agreement and the nature of the relationship between the physicians and the organization. The agreement passed muster because it provided for compensation based on a percentage of net professional patient billings, it provided for compensation review based on the Medical Group Management Association Physician Compensation Survey, and it provided incentives linked to quality, continuing education and customer service, not the number of patients treated, productivity or net profits. The contractual relationship met many other features of the standard safe harbor guidelines, and to the extent it varied from the guidelines, the variations were justified by the particular hospital's recruiting and retention needs.

As part of their ongoing Form 990 compliance, all providers whose facilities are financed with tax-exempt bonds will need to review their professional services agreements and other types of contracts that may generate private business use. For copies of the private letter ruling, the safe harbor guidelines or other guidance, please contact [Davis Sherman](mailto:dvsherman@Venable.com) at 410.244.7810 or dvsherman@Venable.com.

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