Obtaining 501(c)(3) Status for Professional Medical Corporations

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OBTAINING 501(C)(3) STATUS
FOR PROFESSIONAL
MEDICAL CORPORATIONS

Kenneth L. Levine

INTRODUCTION

Health care organizations and physicians increasingly are challenged by financial, political and competitive changes in the health care environment. Many organizations have integrated professional medical services with traditional hospital services. Integrated delivery systems seek to enhance hospitals' abilities to reduce the number of competitors, compete with managed care programs, negotiate rates of payment for services, and achieve economies of scale.

Most states have laws prohibiting the corporate practice of medicine. In such states, the physician component of an integrated delivery system must be either a professional corporation owned and operated by only licensed physicians, or a non-profit (membership) corporation that has members or a board comprised of only licensed physicians. The Internal Revenue Service (I.R.S.) has traditionally argued such entities cannot obtain tax-exempt status because their primary activity is delivering medical care for the benefit of licensed physicians.

An organization may obtain tax-exempt status under Section 501(c)(3) of the Internal Revenue Code (hereinafter 501(c)(3)) only if the

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*Counsel, Murtha, Cullina, Richter and Pinney LLP, Hartford, CT. B.A., Hobart College, 1974, J.D., Case Western Reserve University School of Law, 1977; LL.M. (Taxation), New York University School of Law, 1983.


2Id.

organization is organized and operated exclusively for one or more exempt purposes. In addition, no part of the net earnings of the organization may inure to the benefit of any private shareholder or individual (generally referred to as insiders). Also, any private benefit from the organization's activities must be incidental in relation to the community benefit conferred by such activities.

At first blush, the exemption requirements discussed above would seem to preclude the granting of tax-exempt status under Section 501(c)(3) to a for-profit professional corporation owned and operated by only licensed physicians or a non-profit (membership) corporation that has members or a board comprised of only licensed physicians. Dividends may be paid to physicians with respect to the stock owned in the professional corporation, and this stock may increase in value allowing a possible liquidation of stock for profit. In contrast, organizations that are tax-exempt under Section 501(c)(3) do not vest dividend or liquidation rights. Similarly, corporations having members or boards comprised of only licensed physicians may be denied tax-exempt status if are operated for the benefit of such physicians rather than for the benefit of the community.

This Article will examine how such corporations have obtained tax-exempt status under Section 501(c)(3) as the physician component of an integrated delivery system by being organized and operated as non-profit organizations or the equivalent of non-profit organizations, subjecting themselves to the control of another tax-exempt entity, either providing sufficient community benefits or serving as an integral part of the other tax-exempt entity.

The benefits of tax-exempt status to the physician components of integrated delivery systems are numerous. First, such status means

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5. Treas. Reg. §§ 1.501(c)(3)-1(c)(2) (as amended in 1990) and 1.501(a)-1(c) (as amended in 1982).
8. See supra note 3.
9. This article does not address other issues relevant to qualification for tax-exempt status, such as structuring the compensation of physicians to prevent them from receiving a private benefit.
exemption from federal income taxes. Additionally, these entities are exempt from state income taxes, although they may be subject to state franchise taxes. Depending upon state law, they may qualify for exemption from state and local property taxes and sales taxes. In addition, they can accept tax-deductible charitable contributions and may be eligible for tax-exempt financing. Also, the hospital components of integrated delivery systems have flexibility in providing recruitment or retention incentives to the tax-exempt physician components of their integrated delivery systems.

BACKGROUND

On January 28, 1998, the I.R.S. issued a determination letter granting tax-exempt status under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended, to United Medical Associates, P.C. (UMA) (the UMA Determination Letter). UMA was a New York for-profit professional corporation created by United Health Services (UHS), the parent organization of a health care system including United Health Services Hospitals, Inc. (UHS Hospitals), to serve as the physician component of the UHS integrated delivery system.

The UMA Determination Letter was the latest in a series of eight determination letters in which the I.R.S. granted tax-exempt status under Section 501(c)(3) to either a for-profit corporation that primarily delivers medical care and is owned and operated by only licensed physicians, or a non-profit (membership) corporation primarily providing medical care and has members or a board comprised of only licensed physicians.

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10Exemption is provided under I.R.C. § 501(c)(3), but a tax on unrelated trade or business income may apply under I.R.C. §§ 511-14.
12I.R.C. § 170.
13I.R.C. § 145.
14In Priv. Ltr. Rul. 95-40-066 (June 16, 1995), the I.R.S. appeared to view a hospital’s recruitment of physicians to underserved rural areas to be associated with a taxable professional corporation, under the control of the hospital, as providing a community benefit.
15Tax Analyst Doc. 98-4838.
16Id.
17See infra notes 18-24. Surgical Service of St. Vincent’s P.C. Determination Letter (Apr. 23, 1997), Tax Analyst Doc. 97-1175, may be a determination letter in which the I.R.S. granted such status to a New York professional corporation, but this letter does not provide any
organizations which have been granted tax-exempt status under Section 501(c)(3) in the previous seven determination letters were:

- Marietta Health Care Physicians: an Ohio for-profit professional corporation created by Marietta Memorial Hospital to serve as the physician component of Marietta Memorial Hospital’s integrated delivery system (the Marietta Determination Letter);\(^{18}\)

- C.H. Wilkinson Physician Network: a Texas non-profit (membership) corporation formed by its sole member, Sisters of Charity of the Incarnate Word, Houston (SCH) to provide medical services at various hospitals operated by its sole corporate member, SCH, and primary care sites, to be expanded to include scientific research and medical education (the Wilkinson Determination Letter);\(^ {19}\)

- Rainier Oncology Professional Services: a Washington not-for-profit professional service corporation formed to support Good Samaritan Community Healthcare (the Rainier Determination Letter);\(^ {20}\)

- Physicians Network, P.C.: a New York for-profit professional corporation formed by Vassar Hospital and St. Francis Hospital to serve as the primary care component of their integrated delivery system (the PNPC Determination Letter);\(^ {21}\)

- North Shore Medical Specialists, S.C.: an Illinois for-profit professional corporation formed by Rush North Shore Medical Center to operate an outpatient medical clinic providing primary care services to patients of Rush North Shore Medical Center and to members of the community (the North Shore Determination Letter);\(^ {22}\)

\(^{22}\)Tax Analyst Doc. 96-31095.
• Saint Vincent Medical Education and Research Institute, Inc.: a Pennsylvania professional non-stock (membership) corporation that was a for-profit professional corporation formed by Saint Vincent Health System to employ physicians to serve the medical needs of people in the community and the patients of Saint Vincent Health Center (the Saint Vincent Determination Letter), and

• Community Care I, Inc.: an Ohio for-profit professional corporation formed to provide clinical medical care in conjunction with Memorial Hospital (the CCII Determination Letter).

These eight determination letters (which will be referred to collectively as the Determination Letters) are important because they reveal the I.R.S. is willing to grant tax-exempt status to corporations organized and operated in states that prohibit the corporate practice of medicine in forms other than a for-profit professional corporation owned and operated only by licensed physicians, or a non-profit (membership) corporation that has members or a board comprised only of licensed physicians. The Determination Letters provide a road map that may be followed to qualify such professional corporations and non-profit corporations as tax-exempt under Section 501(c)(3).

Generally, if the physician component of an integrated delivery system is required by state law to be a for-profit professional corporation owned and operated by only licensed physicians, or a non-profit (membership) corporation that has members or a board comprised of only licensed physicians, the physician component may qualify for tax-exempt status under Section 501(c)(3) by being organized and operated as a non-profit organization, or the equivalent of a non-profit organization. In addition, the corporation must qualify as a “captive” of either the hospital component of the integrated delivery system, or an exempt entity affiliated with the hospital. An organization may qualify as a “captive” if the

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26 See id.
27 See infra notes 32-45 and accompanying text.
28 See infra notes 46-108 and accompanying text.
hospital or affiliated exempt entity has a sufficient degree of financial and structural control over the organization. The “captive” may qualify for tax-exempt status by undertaking activities that provide sufficient community benefit to constitute the “promotion of health” exemption, such as the provision of services to charity care and Medicare and Medicaid patients. Alternatively, the “captive” may derive its tax-exempt status by providing essential services to a hospital and its affiliated exempt entities.

STRUCTURING A NON-PROFIT EQUIVALENT

University of Maryland Physicians, P.A. v. Commissioner, is the only judicial authority recognizing a professional corporation as tax-exempt under Section 501(c)(3). The professional corporation in this case was a faculty group practice with shareholders who were full-time faculty of the University of Maryland School of Medicine and on the clinical staff of the University of Maryland Hospital.

The Tax Court concluded the faculty practice plan met both the organizational and operational tests for tax-exempt status under Section 501(c)(3). Under the Articles of Incorporation, all earnings and assets of the professional corporation were dedicated to the medical school or to a similar exempt organization. In addition, the shareholders had no right to corporate profits, and were entitled to only the par value of their stock, at $1.00 per share, upon the dissolution of the professional corporation. The Tax Court dismissed the argument posed by the I.R.S. that a shareholder’s right to receive $1.00 par value per share upon the dissolution of the corporation meant the corporation’s assets were not

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29 See id.
30 See infra notes 135-246 and accompanying text.
31 See id.
33 Id.
34 Id.
35 Id.
36 Id.
dedicated to charitable purposes. Rather, the Tax Court found S1.00 was a permissible and insubstantial distribution.

Similarly, the for-profit corporations in the Marietta Determination Letter, PNPC Determination Letter, North Shore Determination Letter, CCII Determination Letter, and UMA Determination Letter were all organized and operated as the equivalent of non-profit organizations. They were required to be organized and operated for tax-exempt purposes under Section 501(c)(3), because they were organized and operated in a manner that prevented a shareholder from financially benefitting from his ownership of stock in the professional corporation. Shareholders were not permitted to receive dividends or any appreciation in the stock’s value, and they were not permitted to freely transfer their stock.

STRUCTURING AN ORGANIZATION AS A “CAPTIVE”

The professional corporation in University of Maryland Physicians, P.A. v. Commissioner was essentially controlled by, and, therefore a “captive” of, the medical school. Under the medical service plan of the medical school, the compensation of the faculty members was based upon certain mandated compensation formulas which required a portion of the professional fee income be paid over to the medical school. In addition, salary determinations were controlled by the University chancellor and the Dean of the School of medicine, thus providing adequate safeguards against unreasonable compensation.

According to the Determination Letters, the physician component of an integrated delivery system organized as a professional corporation

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38 Id.
39 See supra note 18.
40 See supra note 21.
41 See supra note 22.
42 See supra note 24.
43 See supra note 15.
44 See supra notes 15, 18, 21, 22, 24.
45 Id.
46 See supra note 32.
47 Id.
48 Id.
owned and operated by only licensed physicians, or a non-profit (membership) corporation that has members or a board comprised of only licensed physicians may be a “captive” of a hospital tax-exempt under Section 501(c)(3) or an entity affiliated with the hospital and similarly exempt. The corporation would qualify as a “captive” if the hospital or entity affiliated with the hospital beneficially owned the stock in the for-profit professional corporation, or otherwise had contractual rights that provided it with a degree of structural and financial control over the for-profit professional corporation or non-profit (membership) corporation.

As presented in the Marietta, PNPC, North Shore, and CCII Determination Letters, a for-profit professional corporation is typically a “captive” of a hospital when its stock is held by a physician on the administrative staff of the hospital. In this scenario, the physician-shareholder is often contractually obligated in a shareholder, employment, trust, or letter agreement to obtain hospital approval of all significant structural and financial matters that may impact upon the tax-exempt status of the corporation. Under such agreement, the physician-shareholder holds the stock in a fiduciary capacity for the benefit of the hospital. Usually, the physician-shareholder must be in a continuing employment or contractual relationship with the hospital that gives the hospital the right to designate any future shareholders. The hospital also typically controls the appointment of directors of the corporation. The structure and other relevant agreements must be legally enforceable. The hospital must not permit a physician-shareholder to benefit financially, either directly or indirectly, from stock ownership; and the hospital must take all necessary action to vigorously enforce its rights under these agreements.

**Marietta Determination Letter**

In Marietta, employment, stockholder, and management agreements were used to provide Marietta Memorial Hospital with a sufficient degree of

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49 See *infra* notes 50-108 and accompanying text.
50 *Id.*
51 *Id.*
52 *Id.*
53 *Id.*
54 See *infra* notes 50-108 and accompanying text.
55 *Id.*
56 *Id.*
financial and structural control over a for-profit Ohio professional corporation. Under the physician employment agreements of the professional corporation, Marietta Memorial Hospital was to directly negotiate compensation with the employee-physicians. In addition, Marietta Memorial Hospital, through its management agreement with the professional corporation, was to establish the fee schedule for the employed physicians. A Stockholder Control Agreement was also entered into by and between the sole physician-shareholder, a licensed physician who was a member of Marietta Memorial Hospital’s administrative staff, Marietta Memorial Hospital, and the professional corporation. In part, under the Stockholder Control Agreement:

(1) Marietta Memorial Hospital controlled the election and removal of the board of the professional corporation;

(2) the physician-shareholder agreed to vote his stock only as approved in advance by Marietta Memorial Hospital; and

(3) Marietta Memorial Hospital had the power to designate a transferee of the stock upon its termination of its employment of the physician-shareholder, or in the event of any offer to sell the stock in the professional corporation by the shareholder-owner.

PNPC Determination Letter

In PNPC, Vassar Hospital and St. Francis Hospital employed shareholder agreements and employment agreements to provide them with sufficient financial and structural control over a New York for-profit professional corporation. Each physician-shareholder-director of the professional corporation was to enter into a Shareholder Agreement with the professional corporation. The Shareholder Agreement provided in part:

See supra note 18.

98 Id.

99 Id.

60 Id.

61 Id.

62 See supra note 21.

63 Id.
(1) if the physician-shareholder-director was disqualified or deceased, Vassar Hospital or St. Francis Hospital, as applicable, had the power to designate the person to whom his stock would be transferred;

(2) the physician-shareholder-director was required to vote his stock to elect specifically named individuals selected by Vassar Hospital or St. Francis Hospital as directors of the professional corporation;

(3) the directors of the professional corporation were instructed to elect named individuals selected by Vassar Hospital or St. Francis Hospital as officers of the professional corporation;

(4) the sale of unpaid, unissued or treasury stock was prohibited without the professional corporation’s resolution passed by unanimous consent, in writing, of the physician-shareholders; and

(5) the Shareholder Agreement could not be terminated or amended without the written consent of Vassar and St. Francis Hospitals.64

Each physician-shareholder-director of the professional corporation was also to enter into Employment Agreements with Vassar Hospital and St. Francis Hospital.65 The Employment Agreements provided, in part, the physician-shareholder-director:

(1) consider each recommendation of the primary care oversight and compensation committee established by Vassar Hospital and St. Francis Hospital to make recommendations to the board concerning compensation for physician-employees, the professional corporation’s budget, management, administrative, and billing services, the establishment of additional practice locations, the level and quality of community services provided by physician-employees, decisions involving cost efficient

64 Id.
65 Id.
operations, long range planning, and actions required for the professional corporation to maintain its status as tax-exempt under Section 501(c)(3);

(2) agree to give Vassar Hospital thirty days notice prior to refusing to act upon or vote in favor of a resolution contrary to a recommendation of the primary committee;

(3) agree that Vassar Hospital had the right to terminate the physician-shareholder director’s employment at any time upon thirty days notice, whereupon he was required to resign as the professional corporation’s officer and director, and transfer his stock to another physician designated by Vassar Hospital or St. Francis Hospital, as applicable, for the nominal sum of $1.00;

(4) agree to a prohibition on the transfer of any unpaid, unissued or treasury stock to any third party;

(5) agree to comply with the terms of the Shareholder Agreement and not to terminate or enter into any amendments to the Shareholder Agreement without the prior written consent of Vassar Hospital or St. Francis Hospital; and

(6) agree to give Vassar Hospital three months notice prior to any vote or consent to certain actions, including the amendment of the Shareholder Agreement; dissolution, merger, consolidation or other corporate reorganization; voluntary bankruptcy or assignment for the benefit of creditors; commencement of any litigation; employment, engagement, or discharge of a physician; sale or lease of real property; borrowing or lending of money; and entering into any agreement with any of the professional corporation’s physician-employees, or renewal, termination or amendment of any such agreement."
North Shore Determination Letter
In North Shore, letter agreements were employed by Rush North Shore Medical Center to provide the center with sufficient financial and structural control over an Illinois for-profit professional corporation.67 The professional corporation's sole physician-shareholder-director, (the Vice President of Medical Affairs of Rush North Shore Medical Center), his wife, and the professional corporation, entered into letter agreements under which the physician and his wife agreed in part:

(1) they would not transfer their stock without the prior written consent of the Rush North Shore Medical Center;

(2) they would vote their stock only in a manner approved in advance by the Rush North Shore Medical Center;

(3) they would not take any actions to amend the professional corporation's bylaws without the prior written consent of the Rush North Shore Medical Center;

(4) they would transfer their stock at any time to a designee as required by the Rush North Shore Medical Center; and

(5) the letter agreements would not be amended or terminated without the prior written consent of the Rush North Shore Medical Center.68

CCII Determination Letter
In CCII, a trust agreement was employed by Memorial Hospital to give it a substantial degree of financial and structural control over an Ohio for-profit professional corporation.69 Under the terms of the Trust Agreement, the physician-shareholder transferred all of his stock in the professional corporation to a Trust for the benefit of Memorial Hospital.70 The physician-shareholder held legal title to the stock as the Trustee of the

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67 See supra note 22.
68 Id.
69 See supra note 24.
70 Id.
The Trust Agreement provided in part:

1. the Trust was revocable, with the Trustor having the sole right to terminate the Trust;

2. the Trustor had the right to appoint a successor Trustee as well as remove the Trustee with or without cause;

3. the Trustee was allowed to vote shares of stock in the professional corporation only after obtaining written consent from the Trustor as to how to vote;

4. the Trustee had the right to remove any director of the professional corporation at any time as directed by the Trustor;

5. the Trustee was prohibited from transferring stock without the prior written approval of the Trustor;

6. the Trustee was prohibited from borrowing funds without the prior written consent of the Trustor; and

7. all successors and assigns of the parties were bound by the terms of the agreement.

The Code of Regulations of the professional corporation provided in part the board of the professional corporation be chosen by the physician-shareholder of the professional corporation from a slate of nominees provided by Memorial Hospital. In addition, shareholder approval was required to acquire a physician practice or assets of a physician practice; employ any person, adopt or amend any employee benefit plan or any terms involving physician compensation; incur any indebtedness; enter into any lease of real property or any other material contract; or to sell or
issue any shares of stock or any other security in the professional corporation. 75

**UMA Determination Letter**

As seen in UMA, 76 atypical factual patterns may also allow a for-profit professional corporation that has stock to qualify as a "captive." In the UMA Determination Letter, UHS had sufficient financial and structural control over a New York for-profit professional corporation to cause the professional corporation to be its "captive." 77 UHS was the sole member of United MedManagement (UMM), UMA, UMM's co-applicant for tax-exempt status under Section 501(c)(3), and UHS Hospitals, which was tax-exempt under Section 501(c)(3). 78

The professional corporation entered into a Service Agreement with UMM. 79 Under the Service Agreement, UMM was to own all tangible assets and employ all staff used by the professional corporation, except for licensed physicians required by New York law to be employed by the professional corporation. 80 UMM was to approve all physician compensation arrangements; approve a joint operating budget for the professional corporation and UMM; approve the establishment of new practice locations; develop long range plans; and oversee community services the professional corporation was to provide. 81 Also, the Service Agreement provided the board of the professional corporation would adopt any action determined by UMM to be necessary to obtain or maintain its tax-exempt status. 82

The physician-shareholders and the professional corporation also entered into a Shareholder Agreement. 83 The Shareholder Agreement provided in part:

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75 Id.
76 See supra note 15.
77 Id.
78 Id.
79 Id.
80 Id.
81 See supra note 15.
82 Id.
83 Id.
(1) if a physician-shareholder was disqualified or deceased, the physician-shareholder’s stock would be sold back to the professional corporation at its par value;

(2) the physician-shareholders would vote their shares to assure full compliance with the Service Agreement and the Hospital Professional Services Agreement between the professional corporation and UHS Hospitals;

(3) the professional corporation would give UMM three months notice prior to any vote or consent to an amendment of the Shareholder Agreement; dissolution, merger, consolidation or other corporate reorganization; voluntary bankruptcy or assignment for the benefit of creditors; commencement of any litigation; sale or lease of real property; borrowing or lending of money; or failure to implement a recommendation made by UMM and/or UHS Hospitals;

(4) no unpaid, unissued or treasury stock would be issued or sold to anyone without the written consent of shareholders of two-thirds of the outstanding shares; and

(5) termination or amendment of the Shareholder Agreement would not be permitted without ninety days prior written notice to UMM and UHS.  

The professional corporation also entered into a Hospital Professional Services Agreement in which the professional corporation agreed to provide a wide variety of physician services to UHS Hospitals. Under the Hospital Professional Services Agreement, the professional corporation’s fees were subject to the approval of UHS Hospitals, and physicians provided by the professional corporation were subject to approval and removal by UHS Hospitals. Finally, the bylaws of the

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24 Id.
25 Id.
26 See supra note 15.
professional corporation required the board of the professional corporation be comprised of members of the medical staff of UHS Hospitals.  

Wilkinson Determination Letter
The Wilkinson, Rainier, and Saint Vincent determination letters involve similar factual patterns which permit a non-profit (membership) corporation to qualify as tax-exempt.

In Wilkinson, although the board of a Texas non-profit (membership) corporation was comprised of only licensed physicians, the bylaws of the corporation reserved certain significant structural and financial powers to SCH’s community board, including the right to amend, alter, or repeal the professional corporation’s Certificate of Incorporation and bylaws. Additionally, the bylaws provided SCH with the right to approve significant actions including:

(1) the annual operating and capital budgets and material ($5,000) deviations from such budgets;

(2) the sale, lease, mortgage or other transfer or encumbrance of real (with no monetary limits) or personal property (starting at $5,000);

(3) the merger, acquisition, consolidation, liquidation, or dissolution of the professional corporation;

(4) the giving and seeking of grants;

(5) physician compensation agreements including benefits and incentives;

(6) the right to elect directors, appoint directors, establish or change the number of directors, and remove directors at any time with or without cause;

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87 Id.
88 See supra note 19.
89 See supra note 20.
90 See supra note 23.
91 See supra note 19.
(7) the settlements of claims and litigation; and

(8) the selection of the professional corporation’s auditors.92

SCH also had representatives on a committee that established, evaluated, and administered physician compensation.93

Rainier Oncology Determination Letter
Rainier contains only a partial discussion of the facts, because the I.R.S. had issued an earlier proposal denying a Washington not-for-profit professional corporation’s application for tax-exempt status under Section 501(c)(3) on the basis that the not-for-profit professional service corporation was not operating exclusively to further exempt charitable, educational, or scientific purposes, and because the corporation operated in a manner that could allow its net earnings to inure to the benefit of its physician-employees.94 For this reason, the Rainier Determination focuses on these two issues.95 Rainier Determination does, however, suggest that Good Samaritan Community Healthcare, the member of the not-for-profit professional service corporation, had control over the corporation.96 Under one of the corporation’s bylaws, Good Samaritan was to negotiate and establish the amount of compensation for all physicians employed by the corporation.97

Saint Vincent Determination Letter
In Saint Vincent, a Pennsylvania professional non-stock (membership) corporation’s board was under the control of Saint Vincent Health System.98 In addition, under the corporation’s bylaws, the corporation’s board needed the concurrence of Saint Vincent Health System to appoint and establish the terms and conditions of employment of the corporation’s executive director, who was to manage the business affairs of the corporation.99 In addition, the board of the corporation needed the

92Id.
93See supra note 19.
94See supra note 20.
95Id.
96Id.
97Id.
98See supra note 23.
99Id.
advance written approval of Saint Vincent Health System in order to alter, amend or repeal the corporation’s Articles of Incorporation or bylaws.100

Beneficial Ownership Versus Contractual Control
A hospital or its exempt affiliate may prefer to contractually control rather than have beneficial ownership in its “captive” professional corporation. In some states, and under some circumstances, the beneficial interest may be subject to claims of creditors of the hospital or its exempt affiliate.101

In the Marietta Determination Letter’s Stockholder Control Agreement, the sole physician-shareholder had legal title to the stock in the professional corporation, and Marietta Memorial Hospital had beneficial title.102 Similarly, in the PNPC Determination Letter, the I.R.S. stated that under the terms of the Shareholder Agreement and the Employment Agreements, the physician-shareholders essentially agreed to hold the stock in the professional corporation in a fiduciary capacity for the benefit of Vassar Hospital and St. Francis Hospital.103 Additionally, the I.R.S. stated in the North Shore Determination Letter that the sole physician-shareholder was holding the stock in the professional corporation in a fiduciary capacity for the benefit of Rush North Shore Medical Center.104 Similarly, the CCII Determination Letter noted under the Trust Agreement, the physician-shareholder held legal title to the stock in the professional corporation and Memorial Hospital held a beneficial interest.105 In contrast, the UMA Determination Letter showed the physician-shareholders presumably had legal and beneficial ownership of the stock in the professional corporation and UMM and UHS Hospitals merely had contractual rights over the professional corporation.106

Contractual control over a for-profit professional corporation may not be considered sufficient control to render the professional corporation a “captive” unless a beneficial interest in the “captive” cannot be obtained under a state’s corporate practice of medicine prohibition, or other

100 Id.
102 See supra note 18.
103 See supra note 21.
104 See supra note 22. The I.R.S. looked at the terms of the letter agreements and certain representations as to their enforceability made by Rush North Shore Medical Center.
105 See supra note 24.
106 See supra note 15.
statutory or regulatory provision. In the UMA Determination Letter, the I.R.S. stated:

In an earlier dictated determination letter, the Service recognized a New York clinic as exempt under Section 501(c)(3) of the Code. During the application process, the Service requested that you make amendments to certain documents to be in conformity with the previous favorable determination. You submitted information indicating that these changes would not comply with written directions you received during the course of your incorporation from the New York Health Department’s Office of Counsel. Therefore, you have adopted a modified operating structure with the characteristics described below.\footnote{107}

The earlier determination letter presumably was the PNPC Determination Letter in which the I.R.S. stated the physician-shareholder essentially held the stock in the for-profit professional corporation in a fiduciary capacity.\footnote{103}

The attempt by the I.R.S. to have certain documents in the UMA Determination Letter conform to the documents in the PNPC Determination Letter shows that the I.R.S. may require a physician-shareholder to hold the stock in a for-profit corporation in a fiduciary capacity for a hospital or entity affiliated with the hospital, rather than merely subject the physician-shareholder to the contractual rights of the hospital or affiliated entity, unless the professional corporation can show such requirement will result in noncompliance with state law. Such a requirement would not have merit. In states with a corporate practice of medicine doctrine allowing legal and beneficial ownership of stock to be split, the I.R.S. should not require the hospital or affiliated entity to have a beneficial interest in the stock, if the mere contractual submission to a sufficient degree of control by the hospital or affiliated entity would have allowed the professional corporation to be a “captive” in a state with a corporate practice of medicine prohibition that does not allow legal ownership to be separated from beneficial ownership.

\footnote{107}{Id.}
\footnote{103}{See supra note 21.}
Granting Tax-Exempt Status to Professional Corporations Only in States With Applicable Corporate Practice of Medicine Prohibition

In *University of Maryland Physicians, P.A. v. Commissioner*, the Tax Court recognized the tax-exempt status of a faculty group practice incorporated as a professional corporation under Section 501(c)(3).\(^\text{109}\) The Tax Court specifically noted the faculty group practice was incorporated as a professional corporation, because it was the only type of corporate entity permitted to practice medicine in Maryland.\(^\text{110}\)

The Determination Letters\(^\text{111}\) demonstrate that a prerequisite to granting tax-exempt status under Section 501(c)(3) to a for-profit professional corporation acting as the physician service component of an integrated delivery system is a state prohibition on the practice of medicine in any other corporate form. In the Marietta\(^\text{112}\) and CCII\(^\text{113}\) Determination Letters, such prohibition was confirmed in an Ohio Attorney General’s opinion. In the PNPC\(^\text{114}\) and UMA\(^\text{115}\) Determination letters, the prohibition was confirmed by a stipulation in an advisory opinion of the New York State Commissioner of Taxation and Finance. In the North Shore Determination Letter,\(^\text{116}\) indications from the Illinois Attorney General and the Secretary of State, as well as references to statutory and judicial authority, revealed the need for a professional corporation structure. In the Saint Vincent Determination Letter, the professional corporation requirement was confirmed by the Pennsylvania Office of the Attorney General.\(^\text{117}\)

In the North Shore Determination Letter, the I.R.S. indicated it could revoke the tax-exempt status of the professional corporation if that entity was not required to incorporate only as a professional corporation because of a change in law.\(^\text{118}\) The I.R.S. noted: "This ruling is based, in part, on


\(^{110}\) *Id.*

\(^{111}\) *See supra* notes 15, 18-24.

\(^{112}\) *See supra* note 18.

\(^{113}\) *See supra* note 24.

\(^{114}\) *See supra* note 21.

\(^{115}\) *See supra* note 15.

\(^{116}\) *See supra* note 22.

\(^{117}\) *See supra* note 23.

\(^{118}\) *See supra* note 22.
the decision in *Berlin v. Sarah Bush Lincoln Health Center*, No. 95-MR-7 (Ill. Cir. Ct., 5th Dist., 1995; aff'd, No. 4-95-0569 (Ill. App. Ct. 1996). In the event that this decision is subsequently reversed or the applicable law in Illinois changes, our conclusion as to the recognition of your organization as one described in Section 501(3) of the Code may be affected."\(^{112}\)

Theoretically, if a for-profit professional corporation incorporated in a state with a corporate practice of medicine prohibition may qualify for tax-exempt status by becoming a "captive," any for-profit corporation should be able to qualify for tax-exempt status in a like manner. A practical justification for limiting tax-exempt status to those professional corporations required to incorporate only as professional corporations is the administrative burden of determining an organization's tax-exempt status by reviewing documents such as shareholder, employment, trust, letter, and management agreements, which would be necessary to support an organization's status as a "captive."

**Violations of the Corporate Practice of Medicine Prohibition as Grounds for Revocation of Tax-Exempt Status**

The corporate practice of medicine prohibition is intended to protect the public from abuses stemming from the commercial exploitation of the practice of medicine.\(^{120}\) The prohibition is intended to prevent lay persons from having control over the judgment of medical professionals.\(^{121}\) Additionally, the professional physician-patient relationship is protected by avoiding a situation where a physician has a dual loyalty to a patient and to his employer-contractor.\(^{122}\) The corporate practice of medicine prohibition also reflects concern that corporations are likely to be more interested in profit than with a patient's well-being or quality of care.\(^{123}\) Finally, the corporate practice of medicine prohibition

\(^{119}\) *Id.* The decision was reversed in *Berlin v. Sarah Bush Lincoln Health Ctr.*, 688 N.E. 2d 106 (Ill. 1997), holding a hospital may employ licensed physicians as an exception to the corporate practice of medicine prohibition. Because the prohibition was left otherwise intact, the reversal should not affect the tax-exempt status of the organization.


\(^{122}\) *Id.*

\(^{123}\) *Id.*
exists; because the presence of a corporate entity and the workings of a professional regulatory licensing scheme based on personal qualification, responsibility, and sanction were considered incongruous.\textsuperscript{124}

In the Marietta,\textsuperscript{125} PNPC,\textsuperscript{126} and CCII\textsuperscript{127} Determination Letters, the I.R.S. stated the arrangements whereby the physician-shareholders were holding stock in a fiduciary capacity for a hospital did not violate the corporate practice of medicine prohibition. If a hospital’s holding of stock in a fiduciary capacity, or otherwise exercising control over the professional for-profit corporation or non-profit (membership) corporation, was subsequently determined to be a violation of the corporate practice of medicine prohibition, the tax-exempt status of the for-profit professional corporation or non-profit (membership) corporation could be revoked by the I.R.S.\textsuperscript{128} A charitable trust (and by implication, all charitable organizations) cannot be created for a purpose illegal or contrary to public policy.\textsuperscript{129} In addition, the I.R.S. has consistently followed the principle that the purpose or activity of a tax-exempt organization must not be incompatible with public policy.\textsuperscript{130}

Choosing the Captor

Care should be exercised when selecting the entity having beneficial ownership of the stock in a for-profit corporation, or control of the professional corporation or non-profit (membership) corporation. Under health care laws, making the tax-exempt parent of the hospital the captor may be a better alternative than making the hospital the captor.

For example, under what is commonly referred to as the “72 hour rule” or “DRG Payment Window,” outpatient services (such as radiology and laboratory services) rendered during the three day period immediately preceding a Medicare beneficiary’s admission to a hospital may not be billable as separate services if the services are rendered by a for-profit professional corporation or non-profit (membership) corporation wholly

\begin{itemize}
\item \textsuperscript{124}Id.
\item \textsuperscript{125}See supra note 18.
\item \textsuperscript{126}See supra note 21.
\item \textsuperscript{127}See supra note 24.
\item \textsuperscript{128}See supra note 119.
\end{itemize}
owned or operated by that hospital. Payment for these services may be included in the hospital’s Part A payment for inpatient operating costs. In contrast, if a third organization owns or controls both the hospital and the for-profit professional corporation or non-profit (membership) corporation, then the 72 hour rule/DRG Payment Window does not apply.

QUALIFYING A CAPTIVE AS TAX-EXEMPT

To be exempt under Section 501(c)(3), an organization must be organized and operated exclusively for charitable or other exempt purposes. The organization must engage primarily in activities that accomplish its charitable mission.

In the Determination Letters, the I.R.S. considered whether the “captive” physician component of an integrated delivery system qualified for tax-exempt status under Section 501(c)(3). The I.R.S. based its determination on whether such “captive” satisfied the community benefit standard or the derivative exemption or integral part standard.

Community Benefit Standard

In 1969, the I.R.S. officially ruled that the promotion of health could be a charitable purpose under Section 501(c)(3) only if the community benefit standard was satisfied. This standard is met if a health care organization promotes the health of a broad class of persons by operating an emergency room open to all persons, regardless of their ability to pay, and providing hospital care to all persons who are able to pay the cost of such care either directly or through third party insurance. In 1983, the I.R.S. noted a hospital could meet the community benefit standard even if it does not operate an emergency room, as long as other significant

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132 Id.
133 Id.
134 Id.
136 Id.
137 See supra notes 15, 18-24.
138 See infra notes 139-52.
139 See infra notes 153-64.
factors demonstrate the hospital promotes the health of a class of persons broad enough to benefit the community.\textsuperscript{141}

The 1969 and 1983 I.R.S. rulings set forth other significant factors required to satisfy the community benefit standard.\textsuperscript{142} These factors include the creation of a board of directors drawn from the community, an open medical staff policy, the treatment of Medicare and/or Medicaid patients, and the application of surpluses to facilities, equipment, patient care, medical training, education and research.\textsuperscript{143}

Beginning in 1988, the I.R.S. began applying the community benefit standard to determine whether a component of an integrated delivery system could be recognized as tax-exempt under Section 501(c)(3).\textsuperscript{144} In 1993, the I.R.S. began issuing determination letters granting tax-exempt status under Section 501(c)(3) to components of integrated delivery systems, when such components acquired a physician practice and then retained the physician or physicians as independent contractors or employees.\textsuperscript{145}

In 1993, the I.R.S. announced its requirements for recognizing a component of an integrated delivery system as tax-exempt under Section 501(c)(3).\textsuperscript{146} According to the I.R.S., community benefit may take the form of the integration of all medical functions and records for each individual patient,\textsuperscript{147} or alternatively, by increased accessibility to Medicaid and charity care patients, provision of free care to indigent patients, or provision of nondiscriminatory treatment to Medicare and Medicaid patients.\textsuperscript{148} The open medical staff requirement could be satisfied by looking at the policies of the integrated delivery system

\textsuperscript{142} See supra notes 139, 141.
\textsuperscript{143} Id.
\textsuperscript{146} Exempt Organizations Continuing Professional Education Technical Instruction Program 212 (1993).
\textsuperscript{147} Id.
\textsuperscript{148} Id.
entity's affiliated hospital. Another factor evidencing community benefit is the existence of a conflict of interest policy pursuant to which no board member of the integrated delivery system entity may vote on an issue, motion, resolution or other matter which directly or indirectly may inure to his or her benefit. Also, community benefit is furthered by the conduct of research and the provision of education in the areas of primary and specialty care and general health education programs for the public. Finally, the existence of an independent community board and independent committees or subcommittees of the integrated delivery system entity evidences community benefit.

**Integral Part or Derivative Exemption Standard**

Under the integral part or derivative exemption standard, an organization may qualify for tax-exempt status under Section 501(c)(3) even if it does not engage in inherently exempt activities. Such an organization may qualify for exemption vicariously through related organizations by engaging in activities that would have been exempt if the related organizations had engaged in them.

The integral part or derivative exemption standard has been applied to allow an organization to qualify under Section 501(c)(3) when the organization performed essential services to either its exempt affiliates or to the class of direct beneficiaries of the charitable activities of its exempt affiliates. The derivative exemption or integral part standard has been applied by the courts when the entity seeking derivative exemption provided services bore a close and intimate relationship, were necessary and indispensable, or essential, to a related exempt organization, and would have been performed normal by the exempt organization. The

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149 Id.
150 Id.
151 Id.
152 Id.
153 See infra notes 154-64.
154 Id.
155 Id.
156 See Students Book Corp. v. Commissioner, 191 F.2d 1018 (9th Cir. 1951)
158 See Trustees of Graceland Cemetery Improvement Fund, 515 F.2d 763 (Cl. Ct. 1975).
I.R.S. has also issued specific rulings applying the integral part and derivative exemption standard.\textsuperscript{159}

In *Geisinger Health Plan v. Commissioner*,\textsuperscript{160} the Court of Appeals, Third Circuit, applied a two-pronged test to determine whether the integral part and derivative exemption standard was satisfied.\textsuperscript{161} Under the first prong, the organization must not carry on a trade or business unrelated to the exempt activities of its affiliated entity, if such a business was regularly carried on by the affiliated entity.\textsuperscript{162} Under the second prong, the organization's relationship to its affiliated entity must enhance the organization's own exempt character to the point that the organization itself would be entitled to tax exemption under Section 501(c)(3) when the "boost" provided by the affiliated entity is added to the contribution made by the organization.\textsuperscript{163} Essentially, the organization must be rendered "more charitable" by virtue of its association with its exempt affiliates.\textsuperscript{164}

\textbf{Marietta Determination Letter}

As discussed 	extit{infra}, in the Determination Letters, the I.R.S. has been inconsistent in its application of the community benefit standard and the integral part and derivative exemption standard.\textsuperscript{165} Moreover, these standards have been applied differently in respect to other integrated delivery system entities.\textsuperscript{166}

In Marietta, the professional corporation's Articles of Incorporation contained a conflict of interest policy.\textsuperscript{167} The Code of Regulations restricted to no more than 20 percent of the professional corporation's trustees, the percentage of trustees permitted to be physicians employed by the professional corporation or who directly or indirectly were receiving compensation from the professional corporation for providing clinical services.\textsuperscript{168} The Code of Regulations also provided the board be

\begin{footnotesize}
\begin{enumerate}
\item[\textsuperscript{160}]*Geisinger Health Plan v. Commissioner*, 30 F.2d 494 (3d Cir. 1994).
\item[\textsuperscript{161}]Id.
\item[\textsuperscript{162}]Id.
\item[\textsuperscript{163}]Id.
\item[\textsuperscript{164}]Id.
\item[\textsuperscript{165}]See 	extit{infra} notes 167-249 and accompanying text.
\item[\textsuperscript{166}]See supra notes 146-56 and accompanying text.
\item[\textsuperscript{167}]See supra note 18.
\item[\textsuperscript{168}]Id.
\end{enumerate}
\end{footnotesize}
appointed by Marietta Memorial Hospital.\textsuperscript{169} The professional corporation had a five person board, two of whom were members of the board of Marietta Memorial Hospital and three of whom were administrative personnel of Marietta Memorial Hospital.\textsuperscript{170}

Under physician employment agreements, the professional corporation was to participate in Medicare and Medicaid and provide services to patients without regard to their ability to pay.\textsuperscript{171} The professional corporation submitted budgets listing allowances for charity care, Medicaid, Medicare, and information stating the level of such care.\textsuperscript{172} The professional corporation also obtained Medicare and Medicaid provider numbers.\textsuperscript{173}

The I.R.S. granted tax-exempt status under Section 501(c)(3) to the professional corporation under the integral part or derivative exemption standard.\textsuperscript{174} The I.R.S. stated:

\begin{quote}
[Y]ou are in fact controlled by, operated for the benefit of, and provide an essential service for MMH [Marietta Memorial Hospital], an organization recognized as exempt under Section 501(c)(3) of the Code. This is evident by the facts surrounding your formation and the controls imposed upon your shareholders by the SCA [Stockholder Control Agreement]. As a controlled organization of MMH, you operate as an integral part of the hospital and its integrated delivery system. Because you provide an essential service for MMH and are in effect controlled by MMH, your operations further its exempt purposes. In reaching this conclusion we are relying, in part, on the fact that MMH retains such close supervision and control over your organization and operations that you function as an integral part of MMH.\textsuperscript{175}
\end{quote}

The I.R.S. did not find the professional corporation satisfied the community benefit standard, even though it satisfied the community benefit criteria that had previously been applied to other integrated

\textsuperscript{169} id.
\textsuperscript{170} id.
\textsuperscript{171} id.
\textsuperscript{172} See supra note 18.
\textsuperscript{173} id.
\textsuperscript{174} id.
\textsuperscript{175} id.
delivery system entities. The likely reason for the disparate treatment was the initial reluctance of the I.R.S. to recognize a for-profit professional corporation as tax-exempt under a standard other than the integral part or derivative exemption standard. Perhaps the I.R.S. reasoned that a "captive" for-profit professional corporation by definition must derive its tax-exempt status from its relationship with another tax-exempt entity even if it has satisfied the community benefit standard.

**Wilkinson Determination Letter**

In Wilkinson, the non-profit (membership) corporation adopted a policy of nondiscrimination with respect to Medicare and Medicaid patients, and was committed to providing a level of medical care consistent with its available resources, on an emergent and non-emergent basis, to persons lacking sufficient financial resources. Due to Texas corporate practice of medicine laws, the board was comprised only of licensed physicians. A Network Board Physician Compensation Committee established, evaluated and administered physician compensation. The committee consisted of representatives of the corporation's member, SCH, and other non-physician representatives selected by the president of the corporation. The corporation's bylaws contained a conflict of interest policy.

Based upon the facts surrounding the corporation's formation and operation, the I.R.S. determined the corporation qualified as tax-exempt under Section 501(c)(3) under the integral part or derivative exemption standard. The I.R.S. stated:

> [Y]ou are, in fact, controlled by, operated for the benefit of, and provide an essential service for SCH, an affiliated organization recognized as tax-exempt under Section 501(c)(3) of the Code. This is evident by the facts surrounding your formation and operation. As a controlled organization, you operate as an integral part of SCH's integrated delivery system. Because you

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176 See supra notes 146-53 and accompanying text.
177 See supra note 19.
178 Id.
179 Id.
180 Id.
181 Id.
182 See supra note 19.
provide an essential service for SCH and are subject to SCH's control, your operations furthered its tax-exempt purposes.\textsuperscript{183}

Although the corporation satisfied most of the criteria under the community benefit standard, the corporation did not qualify for tax-exempt status under the community benefit standard; the corporation board consisted only of licensed physicians, lacking any non-physician, independent community members.\textsuperscript{184}

**Rainier Determination Letter**

Rainier does not indicate whether the Washington not-for-profit professional corporation qualified for tax-exempt status under the community benefit standard, or the integral part, or derivative exemption standard.\textsuperscript{185} The Articles of Incorporation stated the corporation was operated exclusively for exempt purposes, including teaching, research, and service programs, and the provision of indigent medical care.\textsuperscript{186} Its bylaws required a conflict of interest policy.\textsuperscript{187}

**PNPC Determination Letter**

In PNPC, the New York for-profit professional corporation had a one person board.\textsuperscript{188} The board member was required to be a licensed physician and to be a member of the medical staff of either Vassar Hospital or St. Francis Hospital.\textsuperscript{189} The Bylaws of the corporation contained a conflict of interest policy.\textsuperscript{190} The board of the corporation was required to consider recommendations of the Primary Committee established by Vassar Hospital and St. Francis Hospital to manage the operations of the corporation.\textsuperscript{191} Vassar Hospital and St. Francis Hospital had boards comprised of civic leaders.\textsuperscript{192}

\begin{itemize}
  \item \textsuperscript{183}Id.
  \item \textsuperscript{184}Id.
  \item \textsuperscript{185}See supra note 20.
  \item \textsuperscript{186}Id.
  \item \textsuperscript{187}Id.
  \item \textsuperscript{188}See supra note 21.
  \item \textsuperscript{189}Id.
  \item \textsuperscript{190}Id.
  \item \textsuperscript{191}Id.
  \item \textsuperscript{192}Id.
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The corporation adopted a separate charity care policy. In addition, nondiscriminatory services were provided to Medicare and Medicaid patients. Services were also provided to indigent patients, and a sliding fee scale was utilized for patients who were unable to pay their charges in full. The corporation’s Medicare and Medicaid policy included access to all covered in-patient and out-patient and diagnostic services that were available to non-Medicare and Medicaid patients. The corporation participated in Medicaid under fee-for-service arrangements at all of its clinic locations, as well as serving Medicaid patients enrolled in managed care plans.

The I.R.S. appeared to have granted tax-exempt status to the corporation under the community benefit standard. The I.R.S. determined the corporation met the requirements of federal tax exemption; its structural and financial components were, in fact, controlled by the primary committee comprised of independent civic members chosen equally by Vassar Hospital and St. Francis Hospital, both organizations recognized as a exempt under Section 501(c)(3). In essence, through the terms of the bylaws, employment agreement and shareholder agreement, the primary committee acted as the corporation’s community board of directors, and Vassar Hospital and St. Francis Hospital retained ultimate control over the corporation’s activities and finances. The I.R.S. noted the corporation’s operations furthered exempt purposes under Section 501(c)(3); because it operated as a direct provider of medical services to its community through the provision of nondiscriminatory services to Medicare, Medicaid and indigent patients.

There are perhaps two reasons why the I.R.S. recognized the corporation as tax-exempt under the community benefit standard rather than under the derivative exemption or integral part standard. First, the facts in the PNPC Determination Letter were different from the facts in

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193 See supra note 21.
194 Id.
195 Id.
196 Id.
197 Id.
198 See supra note 21.
199 Id.
200 Id.
201 See supra note 21.
the Marietta\textsuperscript{202} and Wilkinson\textsuperscript{203} Determination Letters. Unlike Marietta and Wilkinson, the corporation in PNPC probably could not have qualified under the integral part or derivative exemption standard, because it was not controlled by a single entity.\textsuperscript{204} Rather its "captors" were two unrelated entities, Vassar Hospital and St. Francis Hospital.\textsuperscript{205}  

Second, after the issuance of the Marietta\textsuperscript{206} and Wilkinson\textsuperscript{207} Determination Letters, but before the issuance of the PNPC Determination Letter,\textsuperscript{208} the I.R.S. liberalized its community board policy. Originally, under a safe harbor developed by the I.R.S. for establishing that the board of an integrated delivery system entity drawn from the community, no more than 20 percent of board members were to represent physicians, management or other interested parties.\textsuperscript{209} Later, the I.R.S. clarified that the 20 percent limit did not apply to salaried managers or administrators of hospital participants in the integrated delivery system.\textsuperscript{210} The I.R.S. also indicated that the 20 percent limitation would apply only to physicians providing services in conjunction with the integrated delivery system.\textsuperscript{211} The I.R.S. stated that any physician selling assets to, employed by, or providing professional services to, or on behalf of, an integrated delivery system, and any physician receiving significant referrals from an integrated delivery system would be subject to the 20 percent limit.\textsuperscript{212}  

Concurrently, the I.R.S. took the position that an integrated delivery system entity's bylaws should state no more than 20 percent of the members of a board committee may be physicians who are financially interested or related directly or indirectly to any owner, partner, shareholder, or employee of the medical group or other physicians providing services in conjunction with the integrated delivery system.
entity.\textsuperscript{213} The 20 percent limit had to be expressly included in the integrated delivery system entity's bylaws.\textsuperscript{214}

In September, 1996, the I.R.S. announced a new policy position concerning the community board requirement.\textsuperscript{215} Under this new policy, a majority of the voting members of the board of a health care organization should be comprised of independent community members.\textsuperscript{216} Therefore, practicing physicians affiliated with a hospital or its affiliates, as well as officers, department heads and other employees of the hospital or its affiliates, cannot constitute a majority of the board of the hospital or its affiliates.\textsuperscript{217} Under the new policy, the board of a subsidiary non-profit health care organization is considered to be comprised of independent community members if it is controlled by an exempt organization, the board of which is comprised of a majority of voting members who are independent community members.\textsuperscript{218}

As the PNPC Determination Letter was issued on October 23, 1996, the I.R.S. may have applied its new policy to the corporation. Thus, although the corporation did not itself have a community board, it was controlled by tax-exempt, community boards.

It may be argued, however, that this policy should not have applied to the corporation; because the corporation was not controlled by a tax-exempt organization, but rather by two tax-exempt organizations. This argument perhaps prevented the I.R.S. from finding the corporation qualified for tax-exempt status under the integral part or derivative exemption standard. The I.R.S. should clarify the basis of its granting of tax-exempt status in this situation.

**North Shore Determination Letter**

In North Shore, the Illinois for-profit professional corporation's bylaws provided for a board consisting of members who were required to be

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\textsuperscript{213} See supra note 210 at 389.
\textsuperscript{214} See supra note 210 at 227-28.
\textsuperscript{216} id.
\textsuperscript{217} id.
\textsuperscript{218} id.
employees or directors of the Rush North Shore Medical Center. The bylaws contained a conflict of interest policy.

The corporation treated indigent patients and patients who were eligible for Medicare and Medicaid benefits. The corporation participated in the residency program at a local medical college by accepting medical residents for training rotations, and accepted medical students from several local medical schools for one month rotations. In addition, some of the corporation’s physicians participated in a lecture series sponsored by the Rush North Shore Medical Center, addressing medical issues of interest to the community and open to the general public. The corporation promised to sponsor no less than twelve free health education seminars or other similar programs for members of the community on an annual basis.

The I.R.S. recognized the corporation as tax-exempt under the integral part or derivative exemption standard. The I.R.S. stated:

[Y]ou are, in fact, controlled by, operated for the benefit of, and provide an essential service for the Medical Center, a Section 501(c)(3) organization controlled by a community Board of Directors. As an organization controlled by the Medical Center, you operate as an integral part of its integrated delivery system. Because you provide an essential service for the Medical Center and are, in fact, controlled by the Medical Center, your operations further its exempt purpose.

It is not clear why the I.R.S. did not grant tax-exempt status to the corporation under the community benefit standard. The determination letter was issued on November 22, 1996, following the issuance of the new I.R.S. policy on community boards and the I.R.S. determination that the professional corporation in the PNPC Determination Letter qualified for tax-exempt status under the community benefit standard. Thus, the

219 See supra note 22.
220 Id.
221 Id.
222 Id.
223 Id.
224 See supra note 22.
225 Id.
226 Id.
corporation's lack of a community board could have been satisfied by the community board of the corporation's "captor," Rush North Shore Medical Center. Perhaps the I.R.S. granted tax-exempt status to the for-profit professional corporation in the PNPC Determination Letter under the community benefit standard only because that corporation's common control by two unrelated organizations precluded it from qualifying under the integral part or derivative exemption standard, and the I.R.S. was still reluctant to issue tax-exempt status to for-profit professional corporations under any standard other than the integral part or derivative exemption standard.

**St. Vincent Determination Letter**

In St. Vincent, the members of the Pennsylvania professional non-stock corporation were licensed physicians. A majority of the voting board of the corporation was comprised of independent community members. In addition, Saint Vincent Health Center's community board controlled the corporation's activities.

The corporation's bylaws prohibited any committee (other than medical and clinical committees) with board delegated powers from being controlled by practicing physicians, principal officers, department heads, and other employees. A conflict of interest policy was included in the bylaws.

The corporation submitted budgets listing allowances for charity care, Medicaid, Medicare, and information stating the levels of such care, including a separate charity care policy. The corporation was to provide the same care to charity and paying patients and provide Medicare and Medicaid patients with access to the same care provided to other patients.

The I.R.S. determined the corporation qualified for tax-exempt status under the integral part or derivative exemption standard. The I.R.S. stated:

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227 See supra note 23.
228 Id.
229 Id.
230 Id.
231 Id.
232 See supra note 23.
233 Id.
234 Id.
[Y]ou meet the requirements of federal tax exemption because your structural and financial components are, in fact, controlled by SVHS [Saint Vincent Health System], a Section 501(c)(3) organization controlled by a community board of directors. As a controlled organization of SVHS, you operate as an integral part of SVHS, SVHC [Saint Vincent Health Center], and its integrated delivery system. Because you provide an essential service for SVHS and are in effect controlled by SVHS, your operations further its exempt purposes.235

As was the case with the North Shore Determination Letter, it is not clear why the I.R.S. did not grant tax-exempt status to the corporation under the community benefit standard. The determination letter was issued on December 17, 1996, again following the issuance of the new policy on community boards and the determination that the professional corporation in the PNPC Determination Letter qualified for tax-exempt status under the community benefit standard. Thus, the corporation’s lack of a community board could have been satisfied by the community board of the corporation’s “captor,” Saint Vincent Health System.

The professional non-stock corporation was a for-profit professional corporation under Pennsylvania law. Perhaps again, the I.R.S. was still reluctant to issue tax-exempt status to for-profit professional corporations under any standard other than the integral part or derivative exemption standard.

**CCII Determination Letter**

In CCII, the Ohio for-profit professional corporation’s board was controlled by Memorial Hospital.236 In addition, the corporation’s bylaws provided the corporation had a community board and community committees, and included a conflict of interest policy.237

The corporation adopted a separate charity care policy that provided it would render care to all individuals without discrimination and regardless of their ability to pay.238

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235 *Id.*
236 *See supra* note 24.
237 *Id.*
238 *Id.*
The I.R.S. determined that the corporation was tax-exempt under the community benefit standard, and stated:

[Y]ou meet the requirements of federal tax exemption because your structural and financial components are, in fact, controlled by the Hospital, a Section 501(c)(3) organization with a community Board of Directors. In essence, through the terms of your Code of Regulations and the Trust the Hospital retains ultimate control over your activities and finances.

Further, you operate as a direct provider of medical services to your community. You provide nondiscriminatory medical services to all individuals regardless of their ability to pay. Therefore, your operations further a Section 501(c)(3) charitable purpose.239

The CCII Determination Letter suggests that the I.R.S. is no longer reluctant to issue tax-exempt status under the community benefit standard to for-profit professional corporations, particularly when they have a board with members drawn from the community.

UMA Determination Letter
In UMA, a New York for-profit professional corporation was controlled by UMM, which had a community board.240 The corporation’s board was comprised of members of the medical staff of the UHS Hospitals.241

The corporation adopted a separate charity care policy,242 and provided nondiscriminatory services to Medicare beneficiaries and Medicaid recipients.243 The corporation also provided services to the indigent and had a sliding fee scale for patients who were unable to pay their charges in full.244 The corporation’s Medicare and Medicaid policy included access to all covered inpatient, outpatient, and diagnostic services that were available to other patients.245 The corporation participated in

239 Id.
240 See supra note 15.
241 Id.
242 Id.
243 Id.
244 Id.
245 See supra note 15.
Medicaid under fee-for-service arrangements at all of its locations and served Medicaid patients enrolled in managed care plans.\textsuperscript{240}

The I.R.S. determined the corporation was tax-exempt under the community benefit standard, stating:

[\text{Y}ou meet the requirements of federal tax exemption because your structural and financial components are, in fact, controlled by UMM, whose Board is comprised of independent civic members chosen by UHS, which is recognized as exempt under Section 501(c)(3) of the Code. In essence ... UMM acts as your community Board of Directors and UHS retains ultimate control over your activities and finances.]

Further, you operate as a direct provider of medical services to your community. You provide nondiscriminatory services to Medicare beneficiaries and Medicaid recipients. You also provide services to the indigent and have a sliding fee scale for patients who are unable to pay their charges in full. Your Medicare and Medicaid policy includes access to all covered inpatient, outpatient, and diagnostic services that are available to non-Medicare and Medicaid patients. Therefore, your operations further a Section 501(c)(3) charitable purpose.\textsuperscript{247}

The UMA Determination Letter is another indication the I.R.S. is no longer reluctant to grant tax-exempt status under the community benefit standard to for-profit professional corporations. In the UMA Determination Letter, the community benefit standard was satisfied even though the corporation's board was comprised of members of the medical staff of UHS Hospitals. Presumably the I.R.S. relied on its new policy concerning community boards and found that the community boards of UMM and UHS satisfied the community board requirement under the new policy.

**CONCLUSION**

The I.R.S. should be commended for recognizing a for-profit professional corporation that is the physician component of a hospital's integrated delivery system, and is controlled by the hospital or its related entity, may

\textsuperscript{240}Id.
\textsuperscript{247}Id.
qualify for tax-exempt status in a state that does not permit the practice of medicine in any other corporate form. The I.R.S. should, however, permit a "captive" to be created by mere contractual control, even in states where the corporate practice of medicine prohibition allows legal ownership to be separated from beneficial ownership.

The I.R.S. should not be reluctant to grant tax-exempt status under the community benefit standard to a "captive" for-profit professional corporation owned and operated by licensed physicians or a non-profit (membership) corporation that has a board or members comprised only of licensed physicians. The corporation should be permitted to satisfy the community board requirement through the community board of the hospital or related entity when the professional corporation or non-profit (membership) corporation does not have its own community board.