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December 10, 1999

County Counsel
County of Los Angeles
648 Kenneth Hahn Hall of Administration
500 West Temple Street
Los Angeles, California 90012-2713

Attention: Mr.

Re: University of Southern California v. County of Los Angeles, et al. Qualification for the College Exemption of Property Leased by Nonprofit Faculty Medical Practice Groups

Dear Mr. :

You have requested a legal opinion from the Board's Legal Division regarding whether certain leased facilities and personal property employed by faculty practice groups associated with the Medical School of the University (U) are exempt from property taxation pursuant to the college exemption. U has commenced litigation in which your office and County are among named defendants to challenge your denial of the college exemption to portions of a building on the U campus used by faculty practice groups for medical clinic purposes for the years 1992-1996.

You have asked, specifically, that we focus our analysis on two issues: (1) whether the lease of U medical school facilities to nonprofit medical corporations comprised of doctors on the U medical school faculty for purposes of conducting a clinical practice, disqualifies the property from the college exemption; and, (2) whether bonus income from the faculty medical practice distributed on a discretionary basis to select faculty, constitutes private inurement in conflict with section 203, subd. (c) of the Revenue and Taxation Code.¹ As will be discussed herein, staff is of the opinion that:

- 1) The leased real property leased by the nonprofit faculty practice groups and the personal property used by them to conduct a clinical practice are exempt as property used exclusively for educational purposes by a nonprofit institution of higher education; and,
- 2) the bonus income paid to select faculty probably does not constitute private inurement, which is prohibited by section 203, subd. (c).

¹ All section references are to the Revenue and Taxation Code unless otherwise indicated.

For purposes of our analysis, you have provided several documents, including a copy of the application for exemption under Internal Revenue Code, section 501 (c) (3) of U Family Medicine, Inc. This document contains several exhibits that include the Articles of Incorporation, Bylaws and the Medical Faculty Practice Plan of U Family Medicine, Inc.

The relevant facts for purposes of our analysis are as follows:

- The Medical School, as part of U , a California nonprofit corporation, has been conferred tax-exempt status by the Internal Revenue Service.
- The U Medical School provides physicians to staff and operate the County Hospital under an affiliation contract with County.
- The U Medical School faculty also staff and operate the U Hospital as a teaching hospital.
- All the full-time faculty members of the U Medical school participate in faculty practice groups, structured as non-profit corporations.
- The faculty practice groups provide medical services at a medical clinic facility in portions of the Health Care Consultation Center building on the U campus and near the two hospitals under an affiliation agreement with the U Medical School.
- The Medical School authorizes these faculty practice groups for several purposes, such as providing required clinical training² for medical students, interns and residents and generating income to support the school.
- The faculty practice groups are directly controlled by U since they are managed by the department chairpersons at the medical school, who serve at the discretion of the Dean of the U Medical School.
- U leases to these nonprofit [faculty practice group] corporations, facilities in the Healthcare Consultation Center Building on campus that are used for the faculty clinical practice, including faculty offices, conference rooms, and waiting rooms.
- The Healthcare Consultation Center was owned by a private for profit corporation and leased to U during the years 1992 through 1996.

² The American Council on Graduate Medical Education requires medical schools to provide 50% of the training of students within a clinical training program.

- U Care, Inc., a separate U nonprofit corporation, contracts with HMO organizations on behalf of the faculty practice groups to provide medical services to the members of prepaid health plans (HMO) at the faculty practice group clinic facility in the Health Care Consultation Center.³
- The majority of the patients who receive medical care at the clinic facility are members of the prepaid HMO plans.
- All the patients are patients of the faculty practice groups, rather than patients of individual doctors.
- All the income generated from the faculty practice groups at the clinic facility are paid into the U School of Medicine medical Faculty Practice Plan.
- Portions of gross receipts of this income are paid to the U School of Medicine for the academic support of the departments.
- The income is used to pay costs of the faculty practice groups such as rent for the clinic facilities and faculty salaries of physicians in the faculty practice groups.
- The budgets of faculty practice groups must be submitted for approval to the Dean of the Medical School.
- The salaries of faculty in the faculty practice groups are determined according to surveys published by the American Association of Medical Colleges that are based on factors such as geographic region, the faculty member's medical degree(s) and professorial rank.
- Some of the income is distributed as bonus income to select faculty, subject to a cap that is three times the [mean] average salary of the faculty at the U medical school.
- There is no indication of the basis for the bonuses to faculty members, merely that the bonuses are determined by the department chairperson after consultation with the Advisory Committee of the Medical Group and with the approval of the Dean. (See § 6.3.6 of the Medical Faculty Practice Plan)

³ An efficient mechanism for the collection of fees charged to patients for services rendered by the clinical faculty does not detract from its exempt purpose of promoting and improving the education received by the students of the medical school. *University of Massachusetts Medical School Group Practice, Petitioner v. Commissioner of Internal Revenue* (1980) 74 T.C. 1299.

I. Whether the lease of U medical school facilities to nonprofit medical corporations comprised of doctors on the U medical school faculty for purposes of conducting a clinical practice, disqualifies the property from the college exemption?

The pertinent provision of the state Constitution exempts from property taxation “Buildings, land, equipment . . . used exclusively for educational purposes by a nonprofit institution of higher education.” (Article XIII, § 3, subd. (e).) The constitutional provision is implemented by section 203 of the Revenue and Taxation Code. The California Courts have held that tax exemption constitutional provisions and statutes are to be construed strictly, but reasonably. (*Cedars of Lebanon Hospital v. County of Los Angeles* (1950) 35 Cal.2d 729, 734-735.) The *Cedars* Court ruled that the rule of strict construction does not require that the narrowest possible meaning be given to the exempting language, rather *a fair and reasonable interpretation is required, with due regard for the ordinary acceptance of the language employed and the object sought to be accomplished*. The Courts have applied this rule to construe “property used exclusively for the purposes of education” to include any facilities that are reasonably necessary for the fulfillment of a generally recognized function of a complete modern college.” (*Church Divinity School v. County of Alameda* (1957) 152 Cal.App.2d 496) Under this test, the courts have exempted housing for faculty and students and a parking lot (*Church Divinity School*, supra at pages 505-506) and have exempted a golf course, used primarily by alumni. (*Board of Trustees of the Leland Stanford Junior University v. County of Santa Clara* (1978) 86 Cal.App.3d 79). The Court rejected the argument that less than 50% use of the golf course by Stanford students destroys its exclusiveness because of the “special relationship of a university to its alumni.” It should also be noted that the Court’s view, albeit dicta, was that this test permits each educational institution, rather than some governmental entity, to decide which facilities are reasonably necessary for the generally recognized functions of a complete modern college or the fulfillment of its mission and primary purpose. (*Board of Trustees of the Leland Stanford Junior University*, supra at page 84)

In this case, the educational purpose of the U Medical School is to educate medical students, which is accomplished through classroom instruction and training at the hospitals and the clinical practices conducted by full-time faculty members organized in faculty practice groups. As indicated above, the U Medical School is subject to the requirement that 50% of its training of medical students must be clinical training. Thus, the clinical practice conducted by the faculty practice groups enables the U Medical School to provide an integral part of medical school education. The clinical training occurs in portions of the Health Care Consultation Center Building used for clinic facilities and offices for the faculty in the faculty practice groups.

The facts indicate that the patient care activities of the faculty practice groups at the clinics cannot be separated from their teaching function, since faculty treating patients are generally accompanied by medical students, interns or residents, and are simultaneously instructing students and demonstrating techniques of patient care. U medical school administrators consider this opportunity for students to observe and assist in the actual treatment of patients a vital and necessary part of their education. Accordingly, personal property and the the portions of this

building used for the clinical practice of the faculty practice groups constitute facilities/personal property that are reasonably necessary for the fulfillment of a generally recognized function of a complete modern medical school, and as such, qualify for exemption as property used exclusively for educational purposes.

The constitutional provision providing the college exemption has been amended since it was initially approved by the electorate, to require the property to be used exclusively for educational purposes *by a nonprofit institution of higher education*. (Article XIII, § 3, subd. (e).) In our view, this requirement is met despite the existence of leases of the property to faculty practice groups. The purpose of the leases is to allocate the cost of leasing the property among the faculty practice groups according to U Counsel, . As indicated above, the faculty practice groups are comprised entirely of full-time faculty of the U Medical School. Further, the faculty practice groups function under the control of department chairpersons, who serve at the discretion of U Medical school administrators. In our view, these facts support a determination on that that the exclusive use of the property for educational purposes is by the U Medical School. It would appear that the leases amount to form over substance and should not serve to disqualify the property from the college exemption.

II. Whether the bonus income paid to select faculty constitutes private inurement, which is prohibited by section 203, subd. (c)?

Subdivision (c) states that an educational institution of collegiate grade is not conducted for profit when it is conducted exclusively for ...educational purposes and *no part of its net income inures to the benefit of any private person*. The issue of what constitutes private inurement within the meaning of subd. (c) of section 203 has not been litigated by the California Courts. Counsel for U , , cites three federal tax court cases in which faculty medical practices have been held not to create private inurement to the doctors conducting the practices under federal income tax law principles. (*B.H.W. Anesthesia Foundation, Inc. v. Commissioner*, (1979) 72 T.C. 681; *University of Massachusetts Medical School Group Practice v. Commissioner* (1980) 74 T.C. 1299; *University of Maryland Physicians, P.A. v. Commissioner* (1981) 72 T.C. 681. As will be discussed herein, staff has reviewed these cases, researched applicable federal authorities, evaluated the facts in this case, and concurs with Mr. 's analysis that the bonuses paid to select faculty practice groups at the U Medical School do not constitute private inurement.

The private inurement doctrine forbids the flow or transfer of income or assets of a tax-exempt organization through or away from the organization, and the use of such income or assets for the benefit of persons associated with the organization for non-exempt purposes. The purpose of the private inurement rule is to ensure that the tax exempt organization is serving exempt interests and not private interests. (Bruce R. Hopkins, The Law of Tax-Exempt Organizations, 7th Ed., §19.1) Thus, the tax-exempt organization must establish that it is not organized and operated for the benefit of private persons, known as "insiders," who have a special, close relationship to

the organization. Insiders may include the creators of the organization, trustees, directors, officers, members of their families. The insider typically has control or influence over the organization by which he or she can cause the use of the organization's assets or funds for his or her private purposes. (Hopkins, supra at §19.3)

The private inurement doctrine does not prohibit the payment of salaries, bonuses or non-cash benefits to persons providing services; rather, the transactions are subject to a standard of reasonableness. It is well established in federal tax law that the payment of reasonable compensation by a tax-exempt organization for services rendered does not constitute private inurement.⁴ The question of whether the compensation is reasonable is to be determined by examining the facts and circumstances of the operations of the nonprofit organization.

It is noteworthy that the U Medical School has set up a similar structure and employed substantially similar procedures to those utilized by the medical schools in the tax court cases, in establishing the faculty medical practice groups. The existence of the following factors, which also exist as to the U faculty practice groups, were construed by the courts as supporting a determination that compensation received by the medical faculty involved in faculty practice groups was reasonable and therefore, did not constitute private inurement.

- The doctors in the nonprofit corporations comprised of the faculty practice groups are full-time, and must devote all their time to the Medical School.
- All the activities of these nonprofit corporations serve the exempt purposes of the Medical School. (See Articles of Incorporation of U Family Medicine, Inc.)⁵
- All the patients are patients of the faculty practice groups, rather than patients of individual doctors.
- All the revenue generated from the faculty practice groups is paid into the U Medical School Faculty Practice Plan, which governs the use/purposes of these funds and requires the following:
- Portions of gross receipts of this income are paid to the Medical School for academic support of the departments and to serve the [exempt] educational purposes of the medical school.

⁴ *Mabee Petroleum Corp. v United States*, (5th Cir.1953) 203 F.2d 872,877.

⁵ The Articles state that the purposes of the non-profit faculty organization include the promotion of health by engaging in the practice of medicine for patients of hospitals affiliated with the U Medical School, the provision of medical medical care to the sick and injured, medical research, and the instruction of medical students.

- All the revenue from the faculty clinical practice benefits the Medical School, and all expenses are subject to the scrutiny and control of the Dean of the Medical School.
- The revenue from the faculty clinical practice pays for its operating costs, and the compensation of medical school faculty members, which is based on an independent survey of medical school faculty salaries by the Association of American Medical Colleges.
- The doctors in the faculty practice groups have no control over their salaries or fringe benefits, (professional liability insurance, license renewals) which must be approved by the Dean of the U Medical School.
- There is no incentive compensation plan or a direct correlation between the fees generated from the patient care activities of the faculty practice groups and the compensation of the faculty which would indicate that the salaries are actually a distribution of profits.
- The compensation in question, in this case, the bonus income to select faculty, is subject to a cap (three times the average salary of the Medical School faculty).
- The decision of whether bonus income will be paid to faculty members is made by the department chairperson after consultation with the Advisory Committee of the Medical Group and with the approval of the Dean.

In *University of Massachusetts Medical School Group Practice*, the facts indicated that the amounts paid to full-time physician members of the group practice *were in addition to an annual base salary* paid by the University from other sources. The total annual compensation, composed of annual base salary and the group practice salary of any full-time physician member, could not exceed *2 ½ times the maximum allowable base salary* established for the appropriate faculty rank by the university trustees. The U Medical Faculty Practice Plan allows the payment of bonus income in addition to faculty salaries to select faculty subject to a cap that is *three times the average salary of the Medical School faculty*.

In *BHW Anesthesia Foundation*, the tax court found that large salaries and non-cash benefits received by the doctors of this nonprofit corporation, who functioned as staff physicians of a hospital's department of anesthesiology and faculty members of the Harvard University Medical School, were reasonable, considering the nature of their services and skills. The court rejected the argument that the salaries were merely a distribution of profits in the guise of salaries. The court noted that the faculty doctors could have earned substantially more in private practice.

The courts found the compensation of physicians in faculty practice groups was reasonable based on a finding that (1) the nonprofit [faculty practice] organizations had exempt purposes, and

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(2) the existence of factors discussed on pages 6-7. Consistent with these decisions, we opine that the bonus income paid to select faculty does not constitute private inurement because of the exempt educational purposes of the U faculty practice nonprofit organization⁶ and the existence of all the factors in the operation of U faculty practice groups that the courts have found supported a finding of reasonableness.

We are returning the documents herewith which you have provided for purposes of this analysis. The views expressed in this letter are only advisory in nature; they represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or any public entity.

Very truly yours,

/s/ Mary Ann Alonzo

Mary Ann Alonzo
Senior Tax Counsel

MAA:tr

prop/prec/genexemp/99/maa

cc:

Mr. Richard Johnson, MIC:63

⁶ See footnote 5 on page 6.