Health Care Alert

IRS Ruling Permits Inclusion of “Friendly PCs” in Consolidated Federal Income Tax Returns

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On December 19, 2014, the Internal Revenue Service (“IRS”) issued a private letter ruling (the “Ruling”) allowing corporations that manage physician practices through a so-called “friendly physician” arrangement to treat the physician practices as members of the corporations’ consolidated tax group for U.S. federal income tax purposes. The Ruling is significant because it demonstrates that management companies, which must use the friendly physician structure in states that prohibit the corporate practice of medicine, can benefit from tax consolidation, which includes the ability to use the losses of the friendly physician entity to offset other taxable income of the management company.

As discussed by our colleagues (see here), many states prohibit general business corporations from employing or contracting with physicians to provide medical services. This prohibition, known as the corporate practice of medicine prohibition, has existed as a public policy for nearly a century. The justification for this doctrine has always been to address concerns about business corporations and profit-maximizing interests interfering with the medical judgment of physicians in the treatment of patients. Depending on the state, the corporate practice of medicine prohibition may be found in statutes, regulations, board of medicine guidance, attorney general opinions, or case law.

In the Ruling, the IRS analyzed a typical friendly physician arrangement in states that prohibit the corporate practice of medicine. Under the arrangement, a parent corporation (“Parent”) owned several subsidiaries that together constituted a consolidated federal tax group (the “Parent Group”). A subsidiary of Parent had entered into various agreements with two professional corporations (“PCs”) owned by a physician shareholder, who had paid a nominal amount to acquire legal title to the PCs’ equity. First, under a management agreement (labelled a “support service agreement”), Parent’s subsidiary performed a broad range of administrative and support services for the PCs in exchange for a fee. Second, the subsidiary entered into a “Director Agreement” with the physician. That agreement required the physician to act as professional director and to perform certain other administrative functions. The subsidiary could terminate the Director Agreement without penalty.

Finally, the subsidiary and the physician shareholder entered into a Restricted Stock Transfer Agreement pursuant to which the subsidiary could require the physician shareholder to transfer the PCs’ shares to another shareholder/entity designated by the subsidiary at any time upon the occurrence of certain enumerated events, which events included any action by the physician intended to result in a sale of the PCs’ assets, a transfer of the PCs’ stock, or any issuance of additional shares. This agreement also prohibited the physician from causing the PCs to make a dividend or to liquidate. The significant transfer restrictions were noted clearly on a stock legend. According to the Ruling, the subsidiary had a right to simply terminate the Director Agreement described above, in which case the equity in the PC would be transferred back to an individual or entity designated by the subsidiary in exchange for the nominal amount originally paid by the physician.

The IRS concluded that the PCs could be treated as members of the Parent Group and therefore would be permitted to join with the Parent Group in filing a consolidated return under Internal Revenue Code Section 1504. The IRS presumably reasoned that despite the legal title held by the physician, the subsidiary exerted a high level of control over the PCs, and ultimately possessed the economic benefits of ownership as well.

The Ruling appears consistent with IRS and judicial precedent, which states that for tax purposes (at least in the consolidation area), “ownership” is to be interpreted as beneficial ownership, and not necessarily bare legal title.

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This manifestation of “substance over form” has been invoked by the IRS and courts in numerous contexts where the relevant inquiry called for a determination of tax ownership. The nearly full control exercised by the subsidiary, along with the fact that the economic upside associated with the PCs rested in the hands of the subsidiary, were the relevant factors in the determination.

Notably, the IRS had issued a similar ruling in 1996 (See PLR 9605015), which had allowed medical practices to join a health insurance company’s consolidated tax group. However, the IRS later revoked that ruling (See PLR 9752025) after discovering that the ownership arrangements involved did not comply with the applicable state law. Interestingly, in the recent Ruling the IRS required a representation that “applicable law does not prohibit the beneficial ownership of stock” in the PCs by the subsidiary. Accordingly, although the Ruling is favorable from a tax perspective to management companies entering into friendly physician arrangements, parties to these transactions must still carefully structure such arrangements to comply with applicable state corporate practice of medicine restrictions. In addition, management companies should be aware that private letter rulings are limited to the specific question and fact pattern involved and may not be relied upon or cited by other taxpayers as precedent.

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