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RSM comment letter addressing friendly doctor transactions

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June 13, 2022

The Honorable Commissioner Charles P. Rettig
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20024

Re: Comments addressing "friendly doctor" transactions, ownership of property for federal income tax purposes, and potential precedential guidance

Dear Commissioner Rettig:

Enclosed please find comments and requests regarding formal guidance with respect to "friendly doctor" transactions and ownership of property for federal income tax purposes.

Friendly doctor transactions are widely prevalent in the United States. They involve one or more professional practice businesses – such as medical, dental, or legal practice businesses – which are associated with professional corporation ("PC") or professional limited liability company ("PLLC") business entities. Many jurisdictions require that the equity of these PC or PLLC business entities be owned by a licensed practicing professional. The friendly doctor transactions provide benefits and burdens of PC or PLLC ownership to a beneficial owner, a party other than the legal entity's nominal equity holder. The beneficial owner is not a licensed practitioner; it typically is a business entity, not a natural person. The nominal equity holder, colloquially, would be the "friendly doctor" in the case of an entity operating a medical practice.

These comments represent the view of RSM US LLP ("RSM"). RSM is the fifth largest public accounting firm in the United States ("U.S.") and is committed to guiding clients through their business challenges. RSM particularly focuses on serving clients in the middle market, which accounts for more than a third of U.S. employment and about 40% of the U.S. gross domestic product.

RSM has prepared and submits the attached comments on its own behalf. RSM has many clients that would be affected by issuance of guidance on this topic. It appears likely to us that thousands of professional practices in the U.S. are conducted through "friendly doctor" structures.

Our comments relate to subject matter discussed in the American Bar Association Section of Taxation's November 18, 2021, letter and accompanying "Comments

Concerning Proposed Revenue Ruling and Revenue Procedure under Section 1504 of the Internal Revenue Code Regarding the Ability of a Professional Corporation to Join in the Filing of a Consolidated Return."[1] Our request and comments, however, are not limited to the corporate consolidated tax return context.

In our experience, many "friendly doctor" structures involve business entities that are not treated as corporations for federal income tax purposes. Federal income tax issues hinging on the identification or determination of a business entity's equity ownership for federal income tax purposes are by no means limited to the entity's ability or inability to join in the filing of a consolidated federal income tax return. The resolution of many other federal income tax issues may depend on determining who is treated as the owner of an entity's equity for federal income tax purposes; our comments' executive summary list some of these issues.

Our comments (1) discuss relevant case law and prior nonprecendential rulings issued by the Service, (2) highlight practical concerns relating to various areas of tax law caused by the current lack of clarity on this subject, and (3) explain why hinging the tax treatment of friendly doctor transactions on uniform enforceability of all relevant contracts is flawed and could have detrimental ramifications.

With regard to the third of these points, it is clear under case law that ownership of property for federal income tax purposes flows from possession of the benefits and burdens of ownership and does not flow from mere ownership of legal title. However, taxpayers and their advisors may argue to the contrary, based on nonprecedential rulings or comments. That is, contrary to federal income tax case law, taxpayers at times assert that that (a) complete enforceability under state law of all relevant contracts addressing the rights of equity ownership is a prerequisite for treating a non-titleholder as a property owner for federal income tax purposes, and (b) absent clear evidence of such complete enforceability, the equity interest's titleholder should be treated as the equity owner for federal income tax purposes without regard to whether any facts evidence the titleholder's possession of any benefits or exposure to any burdens of equity ownership.

We urge the Service to consider our comments in this regard, and our requests regarding guidance on this subject. We would be pleased to discuss these comments with you if that would be helpful. To discuss these comments or related matters, please

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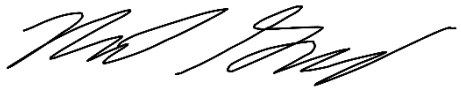
[1] The Internal Revenue Service (the "Service") is currently studying and seeking comments on beneficial ownership in "friendly doctor" structures, according to an agency statement provided to Bloomberg Tax. *See* Slowey, *IRS Open to Suggestions on 'Friendly Doctor' Structure Guidance*, Bloomberg Daily Tax Report (June 9, 2022), available at https://www.bloomberglaw.com/product/tax/bloombergtaxnews/daily-tax-report/X8952ESG000000.

contact Nick Gruidl at Nick.Gruidl@rsmus.com, Stefan Gottschalk at Stefan.Gottschalk@rsmus.com, or Joseph Wiener at Joseph.Wiener@rsmus.com.

Sincerely,



Nick Gruidl

Enclosure

cc:
Hon. Lily Batchelder, Assistant Secretary (Tax Policy), Department of the Treasury
Mark Mazur, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Thomas West, Deputy Assistant Secretary, Domestic Business Tax, Department of the Treasury
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Colin Campbell, Attorney-Advisor, Department of the Treasury
William M. Paul, Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical), Internal Revenue Service
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EXECUTIVE SUMMARY

In recent years there has been a significant increase in mergers and acquisition ("M&A") activity in professional fields such as medicine. One factor leading to this increase has been an influx of private equity ("PE") fund capital. This activity has brought to the forefront the question of ownership of a professional practice for federal income tax purposes.

Typically, when a purchaser desires to acquire a target business, the parties structure an M&A transaction involving the acquisition of either the target's business assets or its equity. Following most M&A transactions, the foundational question of ownership of the business after the transaction is not in question.

However, in the case of M&A transactions involving professional practices such as medical practices, the transaction structure often must address state regulatory limitations. In many states, a professional practice operated by a PC or a PLLC (a "Practice Entity") may be owned only by a licensed practicing professional (a "Professional"). However, the acquirers (i.e., the new beneficial owners) in these transactions often are private equity funds (collectively, along with their managers and affiliates, "PE Funds"), and not a Professional.[2] As a result the transaction is typically structured so that an entity owned by the PE Fund acquires all substantial benefits and burdens of professional practice ownership, while a nominee or "friendly doctor" holds bare legal title to the Practice Entity equity. The entity acquiring (and holding) all substantial benefits and burdens of professional practice ownership generally is called a master service organization or a management company (an "MSO" or a "Management Company"). In a typical situation, the MSO, rather than the "friendly doctor" should under federal income tax case law be treated as the owner of the Practice Entity's equity for federal income tax purposes (the equity's "Tax Owner").

In summary:

1. We request that the Department of the Treasury ("Treasury") and/or the Service issue precedential guidance providing that an MSO holding all substantial benefits and burdens of Practice Entity ownership is treated as the owner of the Practice Entity's equity for federal income tax purposes. Federal tax case law clearly supports this conclusion. The case law focuses on the benefits and

[2] In some instances, the acquirer may be an entity that is not a PE Fund, such as a publicly traded corporation or a hospital. Our comments refer to a PE Fund merely as an example of a beneficial owner who is not a licensed professional in the relevant professional field.

burdens of property ownership in determining the Tax Owner of property.[3] We recommend that the precedential guidance cite the governing federal income tax case law and expressly state that the federal tax law, not state, local, or foreign law, governs the determination of Tax Ownership. As explained in item 2. below, however, accurate federal income tax reporting would be better promoted by not producing any precedential guidance at all than it would be by the release of precedential guidance conditioning (or appearing to condition) its holding that an MSO is treated as the Tax Owner of a Practice Entity on enforceability of all relevant contracts.

2. We recommend that:
    a. The precedential guidance should condition its holding on a fact posited in the guidance – that the MSO holds all substantial benefits and burdens of Practice Entity ownership; and
    b. The precedential guidance should not require enforceability of all of an MSO's contracts as a condition for any aspect of its holding with regard to Tax Ownership. No precedential guidance of any kind with respect to Tax Ownership of a Practice Entity should be conditioned on the enforceability under applicable state law of all of the beneficial owner's relevant contracts.

    There are a number of reasons for these two related recommendations. First, holding benefits and burdens of ownership is what the tax law actually requires to support a finding of Tax Ownership; enforceability of all relevant contracts under state law may be a related concept but is not required.[4] To the MSO, the risk (or fact) that a relevant contract may not be (or is not) enforceable represents a burden of ownership with respect to the Practice Entity it operates and benefits from; that risk (or fact) does not remove the burdens and benefits of ownership from the MSO.

    Second, the risk that a relevant contract may not be enforceable is often cited by drafters of an MSO's (or a Management Company's) contracts as a reason why reporting the nominee friendly doctor as the Practice Entity's Tax Owner on the Practice Entity's federal income tax returns is appropriate, notwithstanding that the friendly doctor does not possess the

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[3] *See*, *e.g.*, *Anschutz Co. v. Comm'r,* 664 F.3d 313 (10th Cir. 2011); *Calloway v. Comm'r*, 691 F.3d 1315 (11th Cir. 2012); *Grodt & McKay Realty, Inc. v. Comm'r*, 77 T.C. 1221 (1981); *Miami National Bank v. Comm'r*, 67 T.C. 793 (1977). *See also* Rev. Rul. 65-218, 1965-2 C.B. 566; Rev. Rul. 72-271, 1972-1 C.B. 369; Rev. Rul. 82-144, 1982-2 C.B. 34.

[4] *See*, *e.g.*, *Anschutz, supra*; *Calloway*, *supra*; *Grodt & McKay*, *supra*.

benefits of equity ownership and has no exposure to the burdens of equity ownership. Any precedential guidance from the Treasury and/or the Service applicable only where all relevant contracts are enforceable would strengthen the appeal of arguments that the nominee friendly doctor, not the MSO, should appear on the tax return as the owner. In our experience, taxpayers' advisors often cite the Service's emphasis – displayed in private letter ruling practice and/or on income tax examination – on contract enforceability as evidence that the Service believes only enforceability of all contracts can convey Tax Ownership. In this regard, we note that it may remain appropriate in the Service's nonprecedential private ruling practice to require representations regarding the taxpayer's relevant contracts, and it may be inappropriate or inefficient for the Service's Office of Chief Counsel to provide legal opinions regarding who holds what rights under state law. Our comments, to be clear, make no recommendations with respect to the Service's private letter ruling practice.

Requiring full enforceability of all relevant contracts in order to report Tax Ownership consistent with principles of case law would represent an unnecessary deviation from the case law, and would likely be counterproductive. Accurate federal income tax reporting would be better promoted by not producing any precedential guidance at all than it would by the release of precedential guidance conditioning (or appearing to condition) any holding contained in any precedential guidance that an MSO is the Tax Owner of a Practice Entity's equity on enforceability of all relevant contracts. Conditioning precedential guidance's holding with respect to Tax Ownership on enforceability of all relevant contracts would likely encourage many additional tax return filings reporting a friendly doctor as a Practice Entity's Tax Owner even where the friendly doctor is a person who neither holds the benefits nor is exposed to the burdens of equity ownership.

3. We further recommend that, when providing precedential guidance (or when considering doing so), Treasury and the Service consider federal income tax consequences of Tax Ownership determinations for friendly doctor structures, including (but not limited to):

    a. The proper federal income tax treatment of the consideration paid by an MSO to enter into a friendly doctor arrangement, including the method(s) an MSO should use to recover its costs capitalized with respect to the acquisition;

b. The potential limitation under section 382,[5] as a result of entry into a friendly doctor arrangement, of a Practice Entity's net operating loss ("NOL") carryforwards under section 172(b), its excess business interest carryforwards under section 163(j)(2), and certain other tax attributes;

c. Whether a qualified business income deduction under section 199A(a) is available to the owners of an MSO that is treated as a partnership for federal income tax purposes;

d. Whether a capital gain exclusion under section 1202(a) is available to the owners of an MSO that is treated as a C corporation[6] for federal income tax purposes;

e. With respect to characterization of an advance as debt or equity for federal income tax purposes, whether the higher level of scrutiny applied to advances received by a business equity from its owner applies to advances from an MSO to a Practice Entity it controls;

f. Whether other tax rules applicable to related parties, such those under section 267, apply to transactions between an MSO and a Practice Entity it controls;

g. Whether an MSO treated as a C corporation and a Practice Entity treated as a corporation for federal income tax purposes may file tax returns as part of a consolidated group of corporations under section 1502 based on their membership in an affiliated group of corporations within the meaning of section 1504.

h. Whether a domestic multi-member Practice Entity LLC that has not elected to be treated as a corporation for federal income tax purposes and that has entered into a friendly doctor arrangement with an MSO is treated as a partnership or disregarded entity for federal income tax purposes.

If Treasury and the Service will issue precedential guidance, we recommend providing examples illustrating some or all of these federal income tax effects of Tax Ownership.

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[5] Unless otherwise stated or clear from the context, all references to "section" in this letter are to the Internal Revenue Code of 1986 (the "Code" or "IRC"), as amended, and references to "Regulation" or "Reg. section" are to regulations promulgated under the Code.

[6] A C corporation is an entity that is treated as a corporation for federal income tax purposes that has not elected pursuant to section 1362 to be treated as an S corporation.

DISCUSSION

Contents

I. The friendly doctor arrangement

a. Contractual provisions' effects on benefits and burdens of Practice Entity ownership

In a friendly doctor acquisition transaction, the parties generally enter into several agreements to convey all substantial benefits and burdens of a Practice Entity to an entity that is not a Professional. One of the agreements is of a type generally called a master services agreement (an "MSA"). Under a typical MSA, the acquiring MSO, legally and beneficially owned by a PE Fund (or by another business entity), agrees to manage the business of the Practice Entity for an annual fee. The annual fee may or may not be fixed or determinable under the terms of the MSA, and often is neither fixed nor determinable. Additionally, the acquiring MSO typically pays the prior beneficial owner of the Practice Entity (who is either (a) a Professional, if the Practice Entity's beneficial owner prior to the acquisition was not an MSO, or (b) an MSO, which was the beneficial owner of the Practice Entity prior to the acquisition and is now selling its beneficial ownership to the acquiring MSO) in order to enter into the MSA.

A Professional (the friendly doctor) will acquire and hold (or will continue to hold) legal title to the Practice Entity's equity at no more than a nominal cost (if any), and without opportunity to economically benefit from appreciation or depreciation in value of the Practice Entity. Instead, the friendly doctor typically will benefit from the receipt of compensation for services he or she provides to the Practice Entity, the MSO, and/or related entities.

This type of arrangement most often addresses medical practices and is therefore often colloquially described as the "friendly doctor" arrangement. However, it is found in other professional practice areas as well, such as mental health, dentistry, and law.

Under typical friendly doctor arrangements, control over the Practice Entity assets and governance and the rights to the Practice Entity's profits are transferred to the MSO. An up-front payment by the MSO is typically compensation to the Practice Entity's prior beneficial owner(s) for these rights. In other words, in the typical situation, the MSA serves to transfer to the MSO the benefits and burdens of the practice entity's ownership.

A typical friendly doctor arrangement includes most or all of the following provisions (the Friendly Doctor Provisions):

- The MSO is provided authority over all aspects of Practice Entity governance, hiring and firing, purchases and sales of assets, and purchases and sales of Practice Entity equity. For example:
    - The MSO may remove the professional in charge of the Practice Entity's delivery of professional services (e.g., the entity's medical director), any

member of a corporate entity's Practice Entity's board of directors (or any LLC managing member or manager) without cause and replace such person with another person chosen by the MSO.

  - The nominal equity holder(s) of the Practice Entity are prohibited from taking any of the following actions without the written consent of the MSO: selling or disposing of Practice Entity equity in any manner, causing the Practice Entity to sell or distribute any of its assets, causing the Practice Entity to liquidate or dissolving the practice entity, or causing the Practice Entity to distribute any cash or other property. In addition, upon any attempt to perform one or more of these prohibited actions the nominal equity holder will be required to transfer all of the nominal equity holder's Practice Entity equity for minimal consideration to a new friendly doctor appointed by the MSO.

- One or more "lock-box" bank accounts that hold all cash receipts of the Practice Entity are established, which the MSO controls by virtue of a power of attorney or similar unconditional authorization executed by the nominal equity holder (and by others as applicable). The MSO thus is the only entity or person that may authorize payments from the Practice Entity's accounts or access the Practice Entity's cash (or other liquid assets). The bank with custody of the cash or other assets in each such account will honor payment instructions only if they are provided by the MSO.
- An MSA authorizing the MSO to receive payments of management fees from the Practice Entity. The MSA often does not specify dollar amounts for the management fees; the fee amounts may be based upon criteria specified in the MSA. The MSO is often authorized to unilaterally change the management fee amounts to reflect criteria such as current market conditions, the fair market value of the services, etc.
- Title to specific assets used by the Practice Entity in its business often is transferred to the MSO. These assets may include, for example, interests in real property, books and records, and medical, dental, and office equipment.
- The MSO manages and controls all aspects of the Practice Entity's business except for the Practice Entity's provision of one or more specified categories of services that are only permitted to be provided by licensed professionals (e.g., decisions with respect to a patient's medical care, decisions with respect to a client's legal representation, etc.). The Practice Entity's provision of such services is expressly reserved for licensed Professionals, rather than the MSO.

The Friendly Doctor Provisions' terms often are not time-limited when extensions available to the MSO are considered.

An MSO often pays a substantial amount of consideration in exchange for its rights under the Friendly Doctor Provisions. The parties to a transaction of this sort generally view the transaction as an economic equivalent of an acquisition of one or more professional practices.

The consideration paid by the MSO acquiring the Friendly Doctor Provision rights typically exceeds the amount that a management company would pay on an arms-length basis for the rights to a contract to provide management services. The consideration is instead more comparable to the consideration that an unrelated professional would pay to purchase a Practice Entity without any Friendly Doctor Provisions in place. The MSO's payment of this consideration is consistent with the MSO's purchase of the full economic benefits of Practice Entity ownership.

In other situations, for example where the MSO is first entering a jurisdiction, the MSO may create a new Practice Entity with a new or existing friendly doctor. In these situations, the MSO and not the friendly doctor typically funds the new Practice Entity, including the purchase consideration for the Practice Entity's assets.

b. Potential state law limitations on benefits and burdens of Practice Entity ownership

The benefits associated with Practice Entity equity ownership – the benefits flowing from control of the Practice Entity's, assets, governance, and business management – are viewed by MSOs as valuable, as noted above. These benefits are subject to risks, of course, including risks associated with states' laws governing Practice Entities' business operations and equity ownership.

The risks that these state laws present to a Practice Entity represent a burden of the Practice Entity's equity ownership. A Practice Entity that runs afoul of these laws might face, for example, (A) an injunction against the Practice Entity's further provision of services,[7] or (B) an inability to demand reimbursement from an insurance provider for services provided by the Practice Entity.[8]

These state laws are diverse, and many present diverse risks. The applicable state laws typically include statutory elements and may include common law and/or administrative

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[7] *See*, *e.g.*, *California Association of Dispensing Opticians v. Pearle Vision Center, Inc.,* 143 Cal. App. 3d 419 (4th Dist., Div. One, 1983).

[8] *See, e.g., Carothers v. Progressive Ins. Co.*, 33 N.Y.3d 389 (2019).

law elements too.[9] They vary considerably from state to state. These state laws are sometimes referred to as the "corporate practice of medicine doctrine," and numerous law review articles examining or surveying these laws are available.[10] Many of these articles note uncertainties regarding the state of the law in this area.

One commentator noting limitations and risks that the corporate practice of medicine doctrine presents to business arrangements in the medical field stated:

> the corporate practice of medicine doctrine continues to influence how health care organizations are structured and managed today. . . . The prevailing view is that while corporate practice prohibitions have been weakened, they remain 'legal landmines,' remnants of an old and nearly forgotten war, half-buried on a field fast being built up with new forms of health care organizations.[11]

Others have commented on the doctrine's uncertain applicability and or underpinnings:

> Why . . . are the applicable laws so multiform, so porous, and so erratically enforced? Are they informed by a single coherent underlying principle, or several? . . . the [corporate practice of medicine] doctrine is often manifested in a largely incoherent and unpredictable array of state-based laws, legal precedents, and expert opinions, creating a shaky framework that judges continue to disparately enforce in a varied manner.[12]

Another commentator noted:

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[9] *See*, *e.g.*, Fichter, *Owning a Piece of the Doc: State Law Restraints on Lay Ownership of Healthcare Enterprises*, 39 Hosp. L. 1 (Winter 2006); Scheffler, *The Dynamism of Health Law: Expanded Insurance Coverage as the Engine of Regulatory Reform*, 10 U.C. Irvine L. Rev. 729 (March 2020); Borsody, *Practice Management Contracts: State of the Law*, 6 N.Y. City L. Rev. 11 (Summer 2003); Markenson and Humphreys, *What Is … the Corporate Practice of Medicine and Fee Splitting: the Fee Splitting Prohibitions*, 33 Health Lawyer 51 (Feb. 2021); Hayward, *Revising Washington's Corporate Practice of Medicine Doctrine*, 71 Wash. L. Rev. 403 (1996); Hall, *Institutional Control of Physician Behavior: Legal Barriers to Health Care Cost Containment*, 137 U. Pa. L. Rev. 431 (Dec. 1988). Marous, *The Corporate Practice of Medicine Doctrine: An Anchor Holding America Back in The Modern and Evolving Healthcare Marketplace*, 70 DePaul L. Rev. 157 (2020).

[10] *See, e.g.,* Fichter, *supra*; Scheffler, *supra*; Borsody, *supra*; Hayward, *supra;* Hall, *supra*; Marous, *supra.*

[11] Fichter, *supra (internal citations omitted).*

[12] Marous, *supra.*

> Crafting the relationships between the professionals and the businessmen is difficult without some kind of legal guidelines. The cases discussed [in this article] give conflicting signals that, hopefully, will be harmonized in the near future.[13]

Interpreting the laws related to the corporate practice of medicine appears to involve considerable uncertainty. It is clear that interpretation of these laws is beyond the legerdemain of most taxpayers and income tax return preparers. Taxpayers and their income tax return preparers typically are not able to provide or receive any clear conclusion regarding the degree to which the contracts used in a taxpayer's friendly doctor arrangements are enforceable or unenforceable under state law.

However, it typically is relatively clear to the taxpayer and the income tax return preparer that the MSO bears the burdens and benefits of Practice Entity ownership. As noted above, a transaction involving an entry into a new MSA by an MSO and a Practice Entity typically is viewed by the parties to the transaction as an acquisition of the Practice Entity, as discussed above, based on the MSO's acquisition of rights under the Friendly Doctor Provisions.

In the context of financial reporting under Generally Accepted Accounting Principles, taxpayers often must assess whether a Practice Entity should be consolidated with an MSO. Discussion of this issue in financial statements filed with the Securities and Exchange Commission reflects taxpayers' consideration of the MSO's control over Practice Entity management and governance in determining whether consolidation is required, and taxpayers' resolution of this type of financial accounting consolidation question without a need for resorting to proofs regarding the enforceability of all relevant contracts.[14]

In these circumstances, it is imperative that any precedential guidance providing any holding regarding whether an MSO is considered the Tax Owner of Practice Entity equity condition its holding on bearing the benefits and burdens of ownership, as dictated by federal income tax case law. Conditioning such a holding in precedential guidance instead on the enforceability of all relevant contracts under state law would represent not only an unwarranted departure from federal case law, but would fail to provide clarity to taxpayers and would likely result in further diversity of practice with respect to tax return positions taken by similarly treated taxpayers. Precedential guidance conditioning the Tax Ownership result on an enforceability determination that

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[13] Barsody, *supra*

[14] *See, e.g.,* Form 10-K of Apollo Medical Holdings, Inc. for the year ended Dec. 31, 2021 (available at https://www.sec.gov/Archives/edgar/data/0001083446/000162828022004291/ameh-20211231.htm); Form 10-K of Virtual Radiologic Corporation for the year ended Dec. 31, 2009 (available at https://www.sec.gov/Archives/edgar/data/0001361579/000095012310014227/c55801e10vk.htm).

taxpayers and their income tax preparers are ill-equipped or unable to make would be akin to precedential guidance authorizing elective resolution of Tax Ownership determinations.

II. Equity ownership for U.S. federal income tax purposes

The principle that the substance of a transaction, rather than its form, should determines its tax consequences dates back at least to the Supreme Court's opinion in *Gregory v. Helvering*.[15] The Supreme Court has since emphasized the substance over form principle on many occasions in statements such as this one: "The Court has never regarded the simple expedient of drawing up papers as controlling for tax purposes when the objective economic realities are to the contrary."[16]

It is true that in some situations a transaction's form determines its tax treatment.[17] In determining Tax Ownership, however, substance trumps form. The tax law does not focus merely on legal title, which provides ownership in form. Federal income tax cases have repeatedly and uniformly held that objective economic realities, not legal title, determine Tax Ownership. The Supreme Court has noted that tax law "is not so much concerned with the refinement of title as it is with actual command over the property taxed."[18] The Tax Court has concluded that "[p]ossession of everything but legal title is the equivalent of direct ownership."[19] In the oft-cited *Grodt & McKay* case, the Tax Court addressed a Tax Ownership dispute and stated "[i]t is well settled that the economic substance of transactions, rather than their form, governs for tax purposes."[20] As an

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[15] *Gregory v. Helvering*, 293 U.S. 465 (1935).

[16] *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978). *See also Helvering v. F.R. Lazarus & Co.*, 332 U.S. 126 (1946) (Supreme Court disagreed with the Service's position that the right to depreciation follows legal title, holding instead that the sale and leaseback of property was properly characterized as a financing for federal income tax purposes); *R. Bartels v. Comm'r,* 332 U.S. 126 (1946) (Supreme Court rejected the Service's imposition of social security tax upon a dance hall operator; the Court held that the employees were under federal tax law employees of a band leader and not of the dance hall operator who the parties had agreed should be treated as the employer). Notably, the previous issuance of an administrative notice providing that the parties' attempt to shift employer status in this manner would be respected and the operators would be treated as "employers" did not avail the Service in its attempt to collect the tax in Bartel.

[17] *See, e.g., Estate of Durkin v. Comm'r*, 99 T.C. 561 (1992).

[18] *Corliss v. Bowers*, 281 U.S. 376 (1930).

[19] *Miami National Bank v. Comm'r*, 67 T.C. 793 (1977).

[20] *Grodt & McKay Realty, Inc v. Comm'r*, 77 T.C. 1221 (1981), *citing Gregory v. Helvering*, 293 U.S. 465 (1935).

additional example, the Supreme Court in *Helvering v. Clifford* ruled that a taxpayer who contributed securities to a trust for his wife's benefit did not thereby avoid tax ownership because he had declared himself trustee and the trust instrument granted him the absolute discretion to reinvest or pay out the income to his wife, and the ability to buy, sell, and vote the securities.[21]

Courts' determinations of Tax Ownership hinge on each case's facts and circumstances. In *Grodt & McKay*, the Tax Court listed eight factors that can play a role in the determination of whether ownership has passed from one party to another.[22]

Revenue rulings issued by the Service also exemplify how Tax Ownership can differ from legal ownership. In Rev. Rul. 55-458,[23] a parent corporation purchased all of the outstanding stock of another corporation and the seller placed the purchased stock in escrow as security for delivery of the purchase price. The parent corporation was permitted to include the purchased subsidiary in the filing of its consolidated U.S. federal income tax return for the year of purchase, notwithstanding that the parent corporation was not in possession of the subsidiary's shares.[24]

In Rev. Rul. 70-149,[25] the Service addressed an arrangement where a nominee held the stock of a corporation (S) with the benefits and burdens of ownership reserved by contract for a second corporation (P). The ruling held that the two corporations were

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[21] *Helvering v. Clifford*, 309 U.S. 331 (1940).

[22] These factors are: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest in the property is acquired; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. *Grodt & McKay Realty, Inc., v. Comm'r*, 77 T.C. 1221 (1981). Courts have applied these *Grodt* factors in several cases addressing stock ownership. *See Anschutz, supra*; *Calloway*, *supra*; *Griffin Paper Co. v. Comm'r*, T.C. Memo. 1997-409. When determining Tax ownership of corporate stock, the characteristics of stock ownership should be considered. These characteristics are discussed in *Himmel v. Comm'r*, 338 F.2d 815 (2d Cir. 1964) (ownership of stock involves rights to vote, to participate in current earnings and accumulated surplus, and to share in net assets upon liquidation). *See also* Rev. Rul. 81-289, 1981-2 C.B. 82 (citing the *Himmel* factors); Rev. Rul. 75-512, 1975-2 C.B. 112 (same); Rev. Rul. 75-502, 1975-2 C.B. 111 (same); *Christoffersen v. United States*, 749 F.2d 513 (8th Cir. 1984) (analyzing tax ownership with respect to a variable annuity contract).

[23] Rev. Rul. 55-458, 1955-2 C.B. 579.

[24] *Id. See also Bondy v. Comm'r*, 269 F.2d 463 (4th Cir. 1959), *rev'g* 30 T.C. 1037 (1958) (similarly holding that placement of stock in an escrow account as security for a taxpayer's obligation does not negate taxpayer's Tax Ownership of the stock).

[25] Rev. Rul. 70-469, 1970-2 C.B. 179.

permitted to file a consolidated income tax return, characterizing the situation as presenting a question under section 1504:

> It is uniformly recognized that under circumstances such as those in the instant case the principal is the owner of the share, is in receipt of income when dividends are paid, and realizes gain or loss from the sale or disposition of the share. *Elizabeth Berthold et al. v. Commissioner*, 12 B.T.A. 1306, acquiescence, C.B. IX-1, 5 (1930). The question then, is whether P owns "directly" the share of S within the meaning of section 1504(a) of the Code.[26]

The ruling answered the question it posed in the affirmative. Tax Ownership is "direct" ownership within the meaning of section 1504(a).

In 1977, the Tax Court addressed a similar Tax ownership and consolidation question in *Miami National Bank*.[27] A corporation had placed stock of a second corporation in a securities account, with legal title over the stock granted to a broker, and the stock made subject to claims of the broker's creditors. The court ruled that because the shareholder retained the right to dividends and to vote the shares, the first corporation was treated as owning the stock of the second corporation for purposes of section 1504(a).[28] The first corporation's status as the Tax Owner of the stock was not obviated by the risk of loss presented by the broker's potential use of the stock to satisfy its creditors.

In Rev. Rul. 84-79,[29] the Service addressed a corporation that owned all the outstanding stock of a subsidiary that held aircraft. Federal Aviation Administration (FAA) regulations required that "75 percent of the voting interest of a corporation wishing to register its aircraft with the FAA must be owned or controlled by United States citizens."[30] The corporation was not a U.S. citizen within the meaning of those regulations. It therefore transferred its subsidiary stock to a revocable voting trust, with a U.S. citizen as trustee, to enable the subsidiary to register the aircraft with the FAA. As described in the ruling:

> Under the terms of the trust agreement, the trustee has all voting powers associated with the S stock while the trust agreement is in force. However, the

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[26] Rev. Rul. 70-469 (*citation in original*).

[27] *Miami National Bank v. Comm'r*, 67 T.C. 793 (1977).

[28] *Id*.

[29] Rev. Rul. 84-79, 1984-2 C.B. 190.

[30] Rev. Rul. 84-79, *citing* 14 C.F.R. §47.

> trustee may not vote the S stock in favor of either a sale of substantially all of S's assets or a dissolution of S without P's authorization.
>
> The trust agreement provides that all dividends (except stock dividends) will be paid directly to P. The trustee may not alienate or dispose of any of the S stock without P's authorization. P may remove the trustee at any time without cause and appoint a qualified successor trustee. The trust agreement may be amended or terminated at any time by P and, unless so terminated, will continue for 10 years.[31]

The ruling did not state either whether the trust agreement's provisions were consistent with or in contravention of FAA regulations, or whether all aspects of the trust agreement were enforceable under applicable non-tax law. The Service ruled that the corporation and its parent corporation could join in filing a consolidated return. The ruling's explanation indicates its holding rested on a Tax Ownership determination based on the benefits and burdens of ownership:

> The direct ownership required by the statute is not merely possession of the naked legal title, but beneficial ownership, which carries with it dominion over the property." *Macon, Dublin & Savannah Railroad Co. v. Commissioner,* 40 B.T.A. 1266, 1273 (1939), *acq.,* 1940-1 C.B. 3.[32]

Later court cases determining Tax Ownership also have not hinged on state law definitions of ownership; these cases include the *Grodt & McKay*, *Anschutz*, and *Calloway* cases noted above.[33]

The relative insignificance, for federal income tax purposes, of state law's characterization of equity ownership is further demonstrated by cases addressing whether an arrangement is properly characterized as a partnership for federal income tax purposes, and cases addressing whether an arrangement is properly characterized as indebtedness.

Two foundational Supreme Court cases addressing the meaning of "partnership" for federal tax law purposes are *Tower*[34] and *Culbertson.*[35] In *Tower*, the Supreme Court stated that a partnership "is generally said to be created when persons join together

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[31] Rev. Rul. 84-79.

[32] Rev. Rul. 84-79 (*citation in original*).

[33] *See*, *e.g.*, *Anschutz Co.*, *supra*; *Calloway*, *supra*; *Grodt & McKay*, *supra*.

[34] *Comm'r v. Tower*, 327 U.S. 280 (1946).

[35] *Comm'r v. Culbertson*, 337 U.S. 733 (1949).

their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses."[36] Following *Tower*, the Supreme Court in *Culbertson* stated that the question of whether an enterprise is a partnership for federal income tax purposes depends on whether the parties in good faith and acting with a business purpose intend to join together in the present conduct of an enterprise.[37] The test, wrote the Court, involves a factual determination regarding whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."[38] *Tower* and *Culbertson* established that the crucial inquiry is whether purported partners had the intent to join together in an enterprise the nature of which constituted a partnership under U.S. federal income tax law.

In Rev. Rul. 58-243, the Service considered the question: does the fact that a husband-and-wife partnership is invalid under state law have any effect upon the recognition of the partnership for federal income tax purposes? The ruling answered the question in the negative, and noted:

> numerous court decisions have held that a bona fide partnership between a husband and wife would be recognized for Federal income tax purposes, despite provisions of state law to the contrary. *See, for example Willis B. Anderson v. Commissioner*, 6 T. C. 956, *acquiescence* C. B. 1946-2, 1; *Francis A. Parker v. Commissioner*, 6 T. C. 974, *acquiescence* C. B. 1946-2, 4; *Felix Zukaitis v. Commissioner*, 3 T. C. 814, *acquiescence* C. B. 1944, 31; *R. E. Wing v. Commissioner*, 17 B. T. A. 1028, *acquiescence* C. B. IX-1, 59 (1930); *Alfred T. Wagner v. Commissioner*, 17 B. T. A. 1030, *acquiescence* C. B. IX-1, 56 (1930); and *Albert Kahn v. Commissioner*, 14 B. T. A. 125, *acquiescence* C. B. VIII-2, 27 (1929).[39]

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[36] *Tower, supra* (partnership entered into by husband and wife was not a partnership for tax purposes, as there was no intention for wife to act in the capacity of partner).

[37] *Culbertson, supra.*

[38] *Id.*

[39] Rev. Rul. 58-243, 1958-1 C.B. 255 (*citations in original*). Previously, in the cases cited in the ruling, the Service had taken the litigating position that state law restricting ownership of a partnership interest should dictate federal income tax results. However, the Board of Tax Appeals and the Tax Court repeatedly rejected that litigating position. As recognized In Rev. Rul. 58-243, maintenance of that litigating position also conflicted with the rationale expressed by the Supreme Court in *Comm'r v. Tower*, 327 U.S. 280 (1946). In Rev. Rul. 58-243, the Service finally abandoned that litigating position, modifying 20 of its prior rulings (*see* Rev. Rul. 58-243 for a list of those rulings). However, in FSA 199926014 (Mar. 26, 1999), discussed below, the Service appeared to return to the type of court-rejected position it had abandoned in Rev. Rul. 58-243.

The ruling concluded:

> the fact that a husband and wife could not legally become partners under state law does not necessarily prevent the recognition of the partnership for Federal income tax purposes. Conversely, following the reasoning in the Frances E. Tower case, [*Comm'r v. Frances E. Tower*, 327 U.S. 280 (1946)], the fact that an asserted husband and wife partnership would be valid under state law does not necessarily require recognition of such partnership for Federal income tax purposes.[40]

Courts and the Service have continued to rule that a person prohibited under state law from becoming a partner in a partnership may be treated as a partner in that partnership for federal income tax purposes. For example, in *Nichols*, the Tax Court held that an arrangement between a medical doctor (Harold) and his non-doctor wife (Beulah) for the conduct of a medical practice was a partnership for tax purposes even though state law prohibited the wife from becoming a partner.[41] The court explained:

> Respondent suggests that because of the professional nature of the business, the statutory requirements as to licensing and prohibition against fee splitting by a professional practitioner, and also because of the community property laws of Washington, it is doubtful that a partnership between Harold and Beulah would be held valid under Washington law. ... it is well established that the legality or illegality of the partnership under State law is not determinative of the question whether a partnership exists for Federal tax purposes. *Commissioner v. Tower*, *supra*; Rev. Rul. 58-243, 1958-1 C.B. 255, and cases cited therein.[42]

Similarly in Rev. Rul. 77-332, the Service ruled that individuals not certified as public accountants can be partners of a certified professional accounting partnership for federal income tax purposes even though they are not recognized as partners under state law.[43]

In *Ian T. Allison*, the Tax Court described four factors to consider when determining partnership status.[44] The court (citing *Culbertson* and other cases) stated:

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[40] *Id.*

[41] *Nichols v. Comm'r*, 32 T.C. 1322 (1959).

[42] *Nichols v. Comm'r*, *supra* (citations in original).

[43] 1977-2 C.B. 484.

[44] 35 T.C. Memo 1069 (1976).

> The question of whether a joint venture has been created by the parties is essentially factual with special emphasis placed upon the intention of the parties. In sifting through the facts and circumstances of each case it is well established that they are to be applied against a framework of four basic attributes that are indicative of a joint venture. These attributes include: a contract, express or implied, that a joint venture be formed; the contribution of money, property and/or services by the venturers; an agreement for joint proprietorship and control; and an agreement to share profits.[45]

The Service's private letter rulings similarly indicate that in order for a member to be a "partner" for tax purposes, the member must possess some economic rights in the entity.[46]

For example, in PLR 199914006,[47] the Service discussed an LLC that ostensibly had two members: a general partnership and a corporation owned by that general partnership. The corporation had become a "member" solely through an agreement with the general partnership, but did not own a "membership interest" in the LLC (the pertinent state law provided that an LLC could have a "member" who held no membership interests in that LLC). The corporation's rights were strictly limited, as the corporate member: (i) was not entitled to receive any distributions or income; (ii) could not withdraw; (iii) could not transfer its interest; and (iv) had minimal management, approval, voting, consent, or veto rights.[48]

The Service held that the LLC was not a partnership for federal income tax purposes. The ruling cited *Culbertson* and *Tower*:

> The cases of *Commissioner v. Tower*, 327 U.S. 280 (1946) and *Commissioner v. Culbertson*, 337 U.S. 733 (1949), provide general principles regarding the

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[45] *Id* (*internal citations omitted*).

[46] *See* PLR 199911033 (Mar. 22, 1999) (permitting like-kind exchange treatment where replacement properties were to be received by a two-member LLC that was considered a single-member LLC, because one of the members did not own any economic interest and was given a membership interest solely to increase the LLC's bankruptcy remoteness); PLR 199914006 (Apr. 12, 1999) (where an LLC had a second member that was a corporation wholly owned by the first member, and the second member received no distributions or allocations from the LLC; the LLC was treated as a single member LLC as the second member's right to veto certain actions of the LLC did not make it an owner in the entity); PLR 200201024 (Jan. 4, 2002) (second member's only rights were to prevent the LLC from declaring bankruptcy, liquidating, or engaging in other actions that would impair the creditors' rights; second member was treated as not having ownership in the LLC).

[47] PLR 199914006 (Apr. 9, 1999).

[48] *Id.*

> determination of whether individuals have joined together as partners in a partnership. The primary inquiry is whether the parties intended to join together to operate a business and share in its profits and losses. The inquiry is essentially factual and all relevant facts and circumstances must be examined. Furthermore, it is federal, not state, law that controls for income tax purposes, regardless of how the parties are treated under state law.[49]

PLR 199911033 also cited *Tower* and *Culbertson* as standing for the proposition that the "primary inquiry is whether the parties had the intent to join together to operate a business and share in its profits and losses."[50] The ruling held that a state law member in an LLC was not a partner and a partnership did not exist because the parties did not enter into an arrangement whereby the two partners would share in the business profits.[51]

Some courts have noted that sharing in losses may be a greater indication of a partnership than sharing in profits. For example, in *Duley*, the Tax Court cited *Tower* and *Culbertson* and stated that, absent proof of an intent to form a partnership, a mere profit-sharing agreement would not be taxed as a partnership. The court added: "This is especially true where, as here, the record shows that [the parties] did not agree to share the losses."[52]

The Second Circuit's decisions in the course of the *Castle Harbour* case's lengthy litigation clearly show that an arrangement's economics, not its state law characterization, will determine whether an investor is treated for federal income tax

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[49] *Id.*

[50] PLR 199911033 (Mar. 19, 1999).

[51] *Id*. *See also* GCM 38856 (Mar. 19, 1982) (citing *Culbertson* and focusing on three factors – the obligations of the participants to contribute to the enterprise, their rights to share in the profits, and their rights of control). Both of these pronouncements cite *Luna v. Comm'r*, 42 T.C. 1067 (1964). The Tax Court stated in *Luna* that the following factors should be considered in determining whether a venture constitutes a partnership: (i) the agreement of the parties and their conduct in executing its terms; (ii) whether business was conducted in the joint names of the parties; (iii) whether the parties filed federal partnership returns or otherwise represented to the Service or to persons with whom they dealt that they were joint venturers; (iv) whether separate books of account were maintained for the venture; (v) the contributions, if any, which each party has made to the venture; (vi) whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; (vii) the parties' control over income and capital and the right of each to make withdrawals; and (viii) whether the parties exercised mutual control over and assumed mutual responsibility for the enterprise. *Id.*

[52] *Duley v. Comm'r*, T.C. Memo 1981-246.

purposes as the holder of partnership equity.[53] In that litigation the Second Circuit twice held in favor of the government and concluded that certain bank parties were creditors, not partnership interest or partnership capital holders.[54]

With regard to friendly doctor arrangement, an approach that looks to the non-tax law of each state would depart from the principles now firmly established in both case law and revenue rulings that require reference to an arrangement's economics, rather than its characterization under state law or permissibility under state law, in determining who holds a partnership interest.

The substance over form principle is also well established in the area of characterizing an instrument as debt or equity for federal income tax purposes.[55] The determination of an instrument's character for federal income tax purposes gives little deference to the form of the instrument and instead looks to the underlying economics. The Service has explained that "[t]he characterization of an instrument for federal income tax purposes depends upon the terms of the instrument and all surrounding facts and circumstances analyzed in terms of its economic or practical realities... ."[56]

Debt generally is viewed as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."[57] Courts typically utilize between ten and fourteen factors when making a debt-equity determination.[58] Although some authorities have included, as one of the many factors, an instrument's classification for

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[53] *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006) (*Castle Harbour II*), *rev'g and rem'g* 342 F. Supp. 2d 94 (D. Conn. 2004) (*Castle Harbour I*), *District Court's subsequent opinion on remand*, 660 F. Supp. 2d 367 (D. Conn. 2009) (*Castle Harbour III*), *rev'd*, 666 F.3d 836 (2d Cir. 2012) (*Castle Harbour IV*), *cert. denied*, 136 S. Ct. 796 (2016).

[54] *Castle Harbour II*, 459 F.3d 220; *Castle Harbour IV*, 666 F.3d 836.

[55] *See*, *e.g.*, *Gilbert v. Comm'r*, 248 F.2d 399, 402 (2d Cir. 1957), *on remand*, 17 T.C.M. 29 (1958), *aff'd*, 262 F.2d 512 (2d Cir.), *cert. denied*, 359 U.S. 1002 (1959); *John Kelley Co. v. Comm'r*, 326 U.S. 521 (1946); *Estate of Mixon v. U.S.*, 464 F.2d 394 (5th Cir. 1972); *Fin Hay Realty Co. v. U.S.*, 398 F.2d 694 (3d Cir. 1968).

[56] CCA 200932049 (Aug. 7, 2009).

[57] *Gilbert v. Comm'r*, *supra*. Accordingly, to the extent that an instrument's form provides the unconditional right to payment, its form of is of course highly relevant to its economics.

[58] *See*, *e.g., Bauer v. Comm'r*, 748 F.2d 1365 (9th Cir. 1984); *Dixie Dairies Corp.*, 74 T.C. 476 (1980). Although some authorities have included, as one of the many factors, an instrument's classification for state regulatory purposes, *see*, *e.g.*, Notice 94-47, 1994-1 C.B. 357, courts chiefly focus on other factors, such as the presence of a maturity date. *See*, *e.g.*, *Gilbert v. Comm'r*, *supra*; *Estate of Mixon*, *supra*; *Fin Hay Realty*, *supra*.

state regulatory purposes,[59] courts chiefly focus on other factors, such as the presence of a maturity date and the debtor's capitalization or ability to pay.[60]

The debt-equity determination under these substance over form principles does not depend on the state law characterization of the arrangement. As Professor Plumb explained: "[i]t is generally not enough that the arrangement creates a debt enforceable under state law."[61] Rather, even if the arrangement is treated under applicable state law as debt, it can simultaneously be treated for federal tax purposes as equity; in such a case an entity treated for state law purposes as a creditor is treated for federal income tax purposes as an equity holder.

Federal income tax case law also makes clear the tax law's independence from state law's (or other non-tax law's) commercial prohibitions and regulations where illegal activity is concerned. A non-tax law prohibiting an activity does not render income from the activity immune from federal income taxation,[62] nor does it render expenses from the activity nondeductible (although the Code may, of course, provide for nondeductibility).[63]

III. Under these authorities, the typical MSA involves a shift of ownership to the MSO for federal tax purposes

Under the typical friendly doctor arrangement, the nominee friendly doctor retains legal title to the Practice Entity's equity, while control over the practice entity's management and governance along with the economic benefits of the practice entity's profits and the economic burdens of any decline in business performance are effectively transferred to the MSO. Under settled principles of U.S. federal income tax law, ownership for tax

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[59] *See*, *e.g.*, Notice 94-47, 1994-1 C.B. 357.

[60] *See*, *e.g.*, *Gilbert v. Comm'r*, *supra*; *Estate of Mixon, supra*; *Fin Hay Realty*, *supra*.

[61] Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposa*l, Tax Law Review, Vol. 26, Issue 3 (March 1971), pp. 369-642 at 460 (internal citations omitted).

[62] *Rutkin v. United States*, 343 U.S. 130 (1952), *reh'g denied*, 343 U.S. 952 (1952) (income received through extortion connected with a bootleg whiskey sales operation held taxable); *James v. United States,* 366 U.S. 213 (1961) (holding that income from illegal activity is taxable despite the recipient's legal obligation to make restitution, and overruling *Comm'r v. Wilcox*, 327 U.S. 404 (1946)). *See also Collins v. Comm'r*, 3 F.3d 625 (2d Cir. 1993) (embezzlement from employer); *Pendola v. Comm'r*, 50 T.C. 509 (1968) (bribes received by former employee of the Service).

[63] *Dixie Dairies Corp. v. Comm'r*, 74 T.C. 476 (1980) (holding that rebates or kickbacks paid to customers in excess of amounts permitted by state law allowed to offset taxable income from sales, following *Max Sobel Wholesale Liquors v. Comm'r*, 69 T.C. 477 (1977), and rejecting the rationale of Rev. Rul. 77-244, 1977-2 C.B. 58, *later revoked by* Rev. Rul. 82-149, 1982-2 C.B. 56).

purposes does not hinge on retention of mere legal title to property but instead focuses on the benefits and burdens of ownership.[64] Accordingly, for federal income tax purposes, a friendly doctor acquisition transaction generally represents a transfer of equity ownership from the Practice Entity's prior beneficial owner(s) to the acquiring MSO.

IV. Guidance from the Service addressing ownership of PCs

a. PLR 202049002

The Service addressed the Tax Ownership of a PC's equity in PLR 202049002.[65] In the ruling, Parent and Sub were, respectively, the common parent and a member of a consolidated group of corporations, and an LLC wholly owned by Sub was an MSO. Under applicable state law, a PC was only permitted to engage in the professional practice through a practitioner, and the shares of a PC engaged in the profession were only permitted to be held by a practitioner.

The MSO and the PC entered into agreements that included the following provisions:

- The PC's shareholder was prohibited from transferring any shares of the PC stock, and if he were to do so, the stock would automatically transfer to a transferee designated by Parent for a nominal cost.
- The PC's shareholder was prohibited from declaring a distribution with respect to the PC stock or from issuing additional equity interests.

Parent made several representations, including that:

- The legal arrangements were legally valid and enforceable.
- Applicable state law only prohibited Sub from practicing the PC's profession, controlling the PC's professional decisions, and from legally owning the PC stock, but did not prohibit Sub from beneficially owning the PC stock.

Based on these facts and representations, the Service ruled that the MSA between the parties transferred the PC's voting control and all economic benefit to the MSO. Sub was therefore the Tax Owner of the PC, and the PC was included in the Parent consolidated group.

b. PLR 201451009

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[64] *See, e.g., Anschutz Co., supra*; *Calloway, supra*; *Grodt & McKay*, *supra*.

[65] PLR 202049002 (Dec. 4, 2020).

At question in PLR 201451009 was whether two PCs could join in the filing of a consolidated return.[66] A consolidated group's common parent (Parent) owned a corporate subsidiary (Sub). Each of the PCs was a professional corporation subject to various state laws including the limitation that it could only engage in the profession through professionals and its shares could only be held by professionals. Sub and the PCs were parties to support services agreements under which Sub performed all administrative services on behalf of the PCs and Sub managed the PCs, to the extent such services did not constitute engagement in the profession.

Shareholder, a professional, paid a nominal amount to acquire and hold legal title to the PCs' stock. Shareholder and each of the PCs entered into a Stock Transfer Restriction Agreement, which (i) generally prohibited Shareholder from transferring or disposing of the PCs' stock, (ii) prohibited Shareholder from having a PC make a distribution with respect to its stock or from issuing additional equity interests, and (iii) prohibited Shareholder from consenting to a liquidation or dissolution of a PC without prior consent of Sub.

The Stock Transfer Restriction Agreements required that on the occurrence of certain "transfer events," Shareholder would transfer or would be deemed to transfer all of the shares of the relevant PC to a person or entity identified by Sub. Numerous events constituted a transfer event, including (i) the termination of the support services agreement, (ii) the transfer or attempted transfer of any stock in a PC to a person other than the one designated by Sub, and (iii) Shareholder voting to declare a dividend on the PC shares.

Shareholder and Sub were parties to a Director Agreement pursuant to which Shareholder served as the professional director for the PCs and oversaw and coordinated Sub's business objectives for the PCs. Sub had the right to terminate the Director Agreement without cause or penalty upon a certain number of days' notice and such termination would trigger a transfer event under each of the Stock Transfer Restriction Agreements. Thus, Sub had the right to trigger a transfer event and cause Shareholder to transfer its stock to a person or entity identified by Sub. The taxpayer represented that applicable state law did not prohibit Sub's beneficial ownership of the PCs' stock.

Based upon these facts and representations, the Service ruled that the two PCs were members of Parent's affiliated group. Because Sub could (i) control who owned the stock of the PCs, (ii) trigger a transfer of shares of the PCs to new shareholders, and (iii) control whether a dividend would be declared by the PCs, Sub had the benefits and burdens of ownership and, in substance, was the true owner of the stock of the PCs for federal tax purposes.

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[66] PLR 201451009 (Sept. 9, 2014).

c. FSA 199926014

In a Field Service Advice memorandum, FSA 199926014,[67] the Service addressed Parent, the common parent of a consolidated group. Parent controlled several PCs. Title to the PCs' stock was held by an employee, not by Parent or any non-PC subsidiary of parent. Parent had included those PCs in the filing of its consolidated return based on a PLR issued to Parent permitting it to do so.[68] Parent later requested another ruling to permit certain other PCs to join in the filing of its consolidated return. The Service did not grant the second requested ruling, but instead revoked the first ruling.[69]

The Service held in FSA 199926014 that Parent's previous inclusion of PCs in its consolidated return was erroneous. The FSA concluded:

> Section Y of State X prohibits beneficial ownership of stock in a professional corporation by a shareholder (such as a corporation) other than a licensed individual. Thus, the professional corporation is precluded under § Y of State X from being a member of a consolidated group.[70]

The Service acknowledged that ownership under section 1504(a) does not depend on legal ownership. However, the state law in which the PCs operated precluded beneficial ownership of a PC by anyone other than a licensed individual.

The FSA concluded:

> Section Y of State X prohibits beneficial ownership of stock in a professional corporation by a shareholder (such as a corporation) other than a licensed individual. Thus, the professional corporation is precluded under § Y of State X from being a member of a consolidated group.[71]

The reasoning applied in the FSA was straightforward: A taxpayer cannot have Tax Ownership of property if state law prohibits the taxpayer from having the rights of ownership.

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[67] FSA 199926014 (Mar. 26, 1999).

[68] *See* PLR 9605015 (Nov. 8, 1995).

[69] *See* PLR 9752025 (Sept. 24, 1997).

[70] FSA 199926014.

[71] *Id.*

> Parent cannot have the benefits of owning the New PC stock, nor be responsible for its burdens. In other words, the fact that Parent attempts to claim the benefits, and assign itself the burdens, of owning the New PC stock does not override the specific provision of § Y that precludes such ownership.[72]

Although straightforward, the FSA's reasoning appears flawed. It is akin to reasoning that if state law prohibits an activity, then federal tax law should treat a taxpayer engaging in that activity as if the taxpayer had not engaged in it. This line of reasoning is in conflict with federal income tax case law and revenue rulings issued by the Service.[73] Under well-settled principles of tax law described above, state law does not determine Tax Ownership. Rather, a property's Tax Owner is the person or entity that bears the benefits and burdens of ownership as an economic matter.

V. Federal income tax consequences of Tax Ownership determinations

The lack of clear guidance regarding friendly doctor arrangements has resulted in a tax landscape with much diversity of practice. Some Practice Entities file federal income tax returns treating themselves as owned by MSOs while others file federal income tax returns treating themselves as owned by friendly doctors. The resolution of this Tax Ownership question can have numerous income tax ramifications.

Federal income tax consequences of Tax Ownership determinations for friendly doctor structures, include (but are not limited to) resolution of the following issues.

- Tax treatment of acquisition consideration

When an MSO enters into a transaction that first establishes a new friendly doctor arrangement with a Practice Entity, the parties to the transaction typically view it as an acquisition of a professional practice business. The acquiring party in business acquisition generally must capitalize costs paid or incurred to enter into the transaction under section 263(a). Whether or not the MSO is properly treated as a Tax Owner of the Practice Entity's equity generally will affect which assets' tax basis will include these capitalized costs. Which assets' tax basis includes the capitalized costs will in turn reflect the recovery of the costs – for example, whether and to what extent depreciation or amortization deductions will be available under section 167, section 168, or section 197. Additionally, for the seller in the Practice Entity transaction, the Tax Ownership determination may affect the characterization of the sale proceeds.

- Section 382 limitation

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[72] *Id.*

[73] *See*, *e.g.*, *United States v. James*, *supra*; Rev. Rul. 58-243, *supra.*

As a result of entry into a friendly doctor arrangement, a Practice Entity's utilization of its NOL carryforwards under section 172(b), its excess business interest carryforwards under section 163(j)(2), and certain other tax attributes may be limited under section 382(a). The triggering event for a section 382 limitation is an ownership change (within the meaning of section 382(g)). As a result, a determination of the Practice Entity's Tax Ownership can drive the determination of whether section 382 applies.

- Section 199A qualified business income deduction

The Tax Ownership determination can affect whether an MSO's owners are eligible for the qualified business income deduction under section 199A. Assume that an MSO and a Practice Entity it controls are both domestic limited liability companies that have not made any election under Reg. section 301.7701-3 to be treated as a corporation, and that the Practice Entity provides health care services. If the MSO is treated as a partnership for federal income tax purposes and is the sole Tax Owner of the Practice Entity, the Practice Entity's income would appear ineligible for the qualified business income deduction under section 199A(a) for the owners of the MSO because the income would be viewed as derived from a health care business rather than from a qualified trade or business that is treated as a partnership for federal income tax purposes.[74] If, on the other hand, the MSO is not treated as the Practice Entity's Tax Owner, the MSO's income may be characterized as management fee income, and its owners may be eligible for the section 199A deduction.[75]

- Section 1202 capital gain exclusion

The Tax Ownership determination can affect whether owners of an MSO are eligible for the section 1202 capital gain exclusion on the sale of qualified small business stock. Assume that an MSO treated as a C corporation for federal income tax purposes controls a Practice Entity. If the MSO is not treated as the Practice Entity's Tax Owner, the MSO's income may be characterized as management fee income, and its owners may be eligible for the section 1202(a) capital gain exclusion upon their sale of the MSO stock.[76] If, on the other hand, the MSO is treated as the Practice Entity's Tax Owner, the Practice Entity's income from providing health care services would likely appear on the MSO's federal income tax return (either due to consolidation, if the Practice Entity is treated as a corporation for federal income tax purposes, or due to the Practice Entity being disregarded as an entity apart from its owner under Reg. section 301.7701-3). In

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[74] *See* sections 199A(d)(1), 199A(2)(A), and 1202(e)(3)(A).

[75] *See* sections 199A(d)(1), 199A(2)(A), and 1202(e)(3)(A).

[76] *See generally* section 1202 and section 1202(e)(3)(A) (defining a qualified trade or business).

that situation, the section 1202 exclusion would likely not be available to the MSO owners due to the nature of its income from provision of health care services.[77]

- Debt-equity determinations

MSOs that enter into MSAs with Practice Entities may advance funds to a Practice Entities they control. These advances are often documented as loans. With respect to characterization of such an advance as debt or equity for federal income tax purposes, the higher level of scrutiny applied by courts to advances received by a business equity from its owner would appear to apply to advances from an MSO to a Practice Entity it controls only if the MSO is treated as the Practice Entity's Tax Owner.[78]

- Related party rules

The Tax Ownership determination can affect whether other tax rules applicable to related parties, such as loss disallowance or deduction deferral under section 267, apply to transactions between an MSO and a Practice Entity it controls.

- Consolidated return filing

The Tax Ownership determination can affect whether an MSO treated as a C corporation and a Practice Entity treated as a corporation for federal income tax purposes may file tax returns as part of a consolidated group of corporations under section 1502 based on their membership in an affiliated group of corporations within the meaning of section 1504.

- S corporation status

The Tax Ownership determination can affect whether an MSO treated as a corporation may be treated as an S corporation. Individuals and certain trusts qualify as S corporation shareholders.[79] Corporations, partnerships, and LLCs taxed as partnerships or corporations generally do not qualify as S corporation shareholders.[80] Additionally, an S corporation may issue only one class of stock.[81] Where an MSO that is treated as a corporation or a partnership controls a Practice Entity that is treated as a corporation, whether that Practice Entity may be treated as an S corporation depends on the Tax Ownership determination. If the MSO is treated as the Practice Entity's Tax Owner, S

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[77] *See generally* section 1202 and section 1202(e)(3)(A) (defining a qualified trade or business).

[78] *See e.g.*, *Estate of Mixon*, *supra; Fin Hay Realty*, *supra.*

[79] Section 1361(c).

[80] Section 1361(b).

[81] Section 1361(b)(3).

corporation status would be unavailable. On the other hand, if the friendly doctor is treated as the Practice Entity's Tax Owner, S corporation treatment may be available. Taxpayers in this situation may also consider whether the Practice Entity is treated as if it has issued two classes of stock; if so, S corporation treatment would be unavailable.

VI. Conclusion

We request that Treasury and/or the Service issue precedential guidance providing that an MSO holding all substantial benefits and burdens of Practice Entity ownership is treated as the owner of the Practice Entity's equity for federal income tax purposes. This holding is clearly supports by the federal income tax law discussed above. We recommend that the precedential guidance cite the governing federal income tax case law and expressly state that the federal tax law, not state, local, or foreign law, governs the determination of Tax Ownership. However, accurate federal income tax reporting would be better encouraged by not producing any precedential guidance at all than it would be by the release of precedential guidance conditioning (or appearing to condition) its holding that an MSO is treated as the Tax Owner of a Practice Entity on enforceability of all relevant contracts.

We recommend that:

- The precedential guidance should condition its holding on a fact posited in the guidance – that the MSO holds all substantial benefits and burdens of Practice Entity ownership; and
- The precedential guidance should not require enforceability of all of an MSO's contracts as a condition for any aspect of its holding with regard to Tax Ownership. No precedential guidance of any kind with respect to Tax Ownership should be conditioned on the enforceability under applicable state law of all of the beneficial owner's relevant contracts. Including a contract enforceability condition would represent an unnecessary deviation from the case law, and would likely be counterproductive. Accurate federal income tax reporting would be better encouraged by not producing any precedential guidance at all than it would be by the release of precedential guidance conditioning (or appearing to condition) any holding that an MSO is the Tax Owner of a Practice Entity's equity on enforceability of all relevant contracts. Conditioning precedential guidance's holding with respect to Tax Ownership on enforceability of all applicable contracts would likely encourage many additional tax return filings reporting a friendly doctor as a Practice Entity's Tax Owner even where the friendly doctor is a person who neither holds the benefits nor is exposed to the burdens of equity ownership.

We recommend that, when providing precedential guidance (or when considering doing so), Treasury and the Service consider federal income tax consequences of Tax Ownership determinations for friendly doctor structures, including (but not limited to):

- The proper federal income tax treatment of the consideration paid by an MSO to enter into a friendly doctor arrangement, including the method(s) an MSO should use to recover its costs capitalized with respect to the acquisition;
- The potential limitation under section 382, as a result of entry into a friendly doctor arrangement, of a Practice Entity's NOL carryforwards under section 172(b), its excess business interest carryforwards under section 163(j)(2), and certain other tax attributes;
- Whether a qualified business income deduction under section 199A(a) is available to the owners of an MSO that is treated as a partnership for federal income tax purposes;
- Whether a capital gain exclusion under section 1202(a) is available to the owners of an MSO that is treated as a C corporation for federal income tax purposes;
- With respect to characterization of an advance as debt or equity for federal income tax purposes, whether the higher level of scrutiny applied to advances received by a business equity from its owner applies to advances from an MSO to a Practice Entity it controls;
- Whether other tax rules applicable to related parties, such those under section 267, apply to transactions between an MSO and a Practice Entity it controls;
- Whether an MSO treated as a C corporation and a Practice Entity treated as a corporation for federal income tax purposes may file tax returns as part of a consolidated group of corporations under section 1502 based on their membership in an affiliated group of corporations within the meaning of section 1504.
- Whether a domestic multi-member Practice Entity LLC that has not elected to be treated as a corporation for federal income tax purposes and that has entered into a friendly doctor arrangement with an MSO is treated as a partnership or disregarded entity for federal income tax purposes.

If Treasury and/or the Service issue precedential guidance, we recommend providing examples illustrating some or all of these federal income tax effects of Tax Ownership.

We are pleased to offer these comments setting forth the above recommendations and would be happy to discuss them or related issues with you.