BURR ALERT

Physicians, Surgery Centers and Taxes

By Burr & Forman's Tax Group October 2016

Since the enactment of the net investment income tax ("NIIT") in 2012, physicians and other taxpayers owning multiple business interests have had to make educated choices based upon accounting projections and SWAGS when determining how best to treat ancillary businesses for tax purposes. If an ancillary business is treated as an active trade or business or is otherwise required to be "grouped" with the physician's regular practice under the passive activity rules, the income and/or loss generated by the ancillary business will be treated as ordinary income or loss, and will not be subject to the NIIT. On the other hand, if the physician has unused passive losses from other business investments, being able to treat an ancillary business which actually produces income as a "passive" activity, produces the better income tax result by allowing the passive losses to offset that passive income. The most important decision though comes when the ancillary activity is first acquired and "grouped" with other active or passive activities since that grouping must also be used in subsequent years (absent a material change in facts and circumstances). Treas. Reg. Section 1.469-4(e).

As most physicians are aware, there are some activities which are so closely related to their day-to-day medical practice that such activities must be grouped with the medical practice under the passive activity loss rules. In fact, one of the examples in the passive loss grouping regulations involves a group of physicians who invest in a separate company providing radiological services. After describing why the radiological services are merely a change in form, but not in substance, regarding how such services were historically provided, the regulations conclude that the income from the radiological service company must be grouped with each partner physician's medical practice income for tax purposes. The fact that one of the express reasons for forming the radiological partnership was to create passive income (since all of the physicians had unused passive losses or were planning to acquire passive investments), did not help the physicians with the Service's conclusion. Treas. Reg. Section 1.469-4(f)(2).

However, in a recent technical advice memorandum ("TAM"), the IRS has ruled that it could not force a physician to group his ownership in a surgery center with his medical practice because the physician, among other factors, lacked any ability to control the operations of the surgery center. Therefore, the physician was allowed to treat the income from the surgery center partnership as passive income and net that income against previously unused passive losses arising from rental real estate. In other words, the medical practice was an active trade or business and the surgery center was a separate passive investment activity.

One of the key distinguishing characteristics between the physician's ownership in the surgery center described in the TAM and the radiological partnership described in the regulations was that the physician had invested in a separate entity which was itself a minority owner in the surgery center. The majority owner of the surgery center in the TAM was an unrelated company which built and operated surgery centers

as its main business. Additionally, the minority owner (and its physician investors) were prohibited from having any say in day-to-day operations or management through the organizational documents of the entity which actually operated the surgery center. After also evaluating the five factor test under the passive loss regulations, the TAM concluded that the physician's groupings were not "clearly inappropriate" (i.e., that his ownership in the surgery center was a passive activity). Therefore, the IRS did not have the authority to re-group the activities in a manner different than reported on the physician's tax return. All of which allowed the physician to offset the income generated by the surgery center with previously unused passive losses from rental real estate.

While the tax structure which any taxpayer, whether a doctor, lawyer or Indian Chief, might want with respect to his/her trade or business activities versus investment or passive activities is very fact specific to that taxpayer and his/her overall tax position, what is most important about the holding of this TAM is its recognition that the passive loss rules do not require that certain activities be grouped together automatically merely because the activities are involved in the same industry or constitute the same type of business. The grouping analysis must, in fact, be a facts-and-circumstances based determination relying on the factors outlined in the regulations; (i) similarities and differences in types of trades or businesses; (ii) the extent of common control; (iii) the extent of common ownership; (iv) geographical location; and (v) interdependencies between or among the activities. Treas. Reg. Section 1.469-4(c)(2).

So, if the physician in the TAM had wanted the income to be active in order to avoid the passive loss rules altogether, he probably could have done so by negotiating a different legal structure for his investment in the surgery center. As practitioners know well, the tax laws are driven by legal formalities and in this case, the formalities of having the physician investors collectively own a separate entity to hold a minority interest in the surgery center and being prohibited by "contract" from participating in the day-to-day management of the surgery center allowed the physician in the TAM to treat his indirect ownership in the surgery center as a passive activity, separate and distinct from his medical practice.

Should you have any questions about the implications of TAM 201634022, the passive activity loss rules or the net investment income tax, please contact any of the following Burr attorneys in the offices indicated:

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