OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSOCIATE DISTRICT COUNSEL

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Affiliation of Medical Professional Corporation with a Consolidated Group of Corporations

This Field Service Advice responds to your memorandum dated December 21, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Parent =
Acquiring =

State X =
§ Y =

Year 1 =
Year 2 =

x =
y =

Case X =

ISSUE:

Whether § 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. If that is the case, then the professional corporation is precluded under § Y of State X from being a member of a consolidated group.

CONCLUSION:

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.

BACKGROUND

For the tax years ending Year 1 and Year 2, Parent was the common parent of an affiliated group of corporations filing a consolidated Federal income tax return. Parent included certain professional corporations in its consolidated return for these years after receiving a private letter ruling from the IRS (PLR 9605015, dated November 8, 1995) permitting it to do so. Parent requested another ruling for including other such corporations in subsequent consolidated returns. The IRS not only refused to rule favorably on this request, it also retroactively revoked the prior PLR (PLR 9752025, dated September 24, 1997). The issue is whether Parent properly included these corporations in its consolidated return for the tax years ending Year 1 and Year 2.

FACTS:

For the years at issue, Parent provided healthcare insurance to subscribers and was in the process of developing an integrated health care delivery system designed to service Parent's subscribers throughout State X. As a part of this process, Parent acquired several primary care medical practices using the following acquisition strategy.

Either Parent or Acquiring, a wholly owned subsidiary of Parent, loaned funds to a physician/employee of the Parent group (“Employee”). Employee transferred these funds to a new professional corporation (“New PC”) in exchange for all of the stock of New PC. New PC used these funds to acquire the intangible assets of the targeted medical practice (“Old PC”), employ the physicians selling their practice, and provide medical care to patients. A management services organization, owned by a subsidiary of Acquiring (“Sub”), provided management and administrative services to New PC. Sub acquired the tangible assets of Old PC.

Acquiring structured the acquisition of Old PC this way in an attempt to comply with § Y of State X that prohibits anyone other than a licensed physician from beneficially owning the stock of a professional corporation. Thus, as a result of the transaction, Employee owned legal title in the stock of New PC. However, as described below, Employee's legal ownership of such stock is severely circumscribed.

As noted above, all of the funds used by Employee to acquire the stock of New PC (and by New PC to acquire the intangible assets of Old PC) were loaned to him by either Acquiring or Parent. The loans were evidenced by nonrecourse notes and secured by a pledge of the stock of New PC to Acquiring. Acquiring also holds an open ended option allowing it to acquire at any time all of Employee's stock in New PC.

The pledge agreements provide that Employee must give Acquiring x days notice prior to any exercise of his right to vote the stock of New PC, must consult with Acquiring with regard to any vote, and must give y days notification to Acquiring of his intention with respect to the vote. In the event that Employee does not intend to comply with Acquiring's recommendation with regard to his exercise of the vote, Acquiring will exercise its option to purchase the stock of that New PC through another licenced physician in its employ who will vote in accordance with Acquiring's recommendation. In the event that Employee misrepresents his intentions with regard to the vote, Acquiring will exercise its option to purchase immediately after the vote and demand a revote on the issue.

The pledge agreements further provide that Employee may not receive dividends from New PC and if mistakenly received, provides for the contribution of the dividend to that New PC. To insure that Employee will not profit from any increase in value of New PC, the agreement provides that Acquiring may acquire the stock of New PC from Employee at any time pursuant to the option agreement for an amount equal to the amount paid by Employee for such stock. The nonrecourse nature of the note insures that Employee will not be liable in the event that the stock of New PC declines in value.

Acquiring controls the governance of New PC through its selection of their officers and directors and Sub controls their day to day operations through it authority and responsibility to provide management and administrative services. Sub is ultimately responsible to Acquiring for New PC's operations.

LAW AND ANALYSIS

Law:

I.R.C. § 1504(a)(1) provides that, for purposes of this subtitle, the term "affiliated group" means --

> (A) one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if --
>
> (B)(i) the common parent owns directly stock meeting the requirements of I.R.C. § 1504(a)(2) in at least one of the other includible corporations, and
>
> (ii) stock meeting the requirements of I.R.C. § 1504(a)(2) in each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations.

I.R.C. § 1504(a)(2) provides that the ownership of stock of any corporation meets the requirements of this section if it --

> (A) possesses at least 80% of the total voting power of the stock of such corporation, and
>
> (B) has a value equal to at least 80% of the total value of the stock of such corporation.

Analysis:

As noted above, the issue is whether Parent properly included New PC in Parent's consolidated return. That issue in turn depends upon whether Parent "directly" owned the stock of New PC within the meaning of I.R.C. § 1504(a).

Parent did not have legal title to New PC's stock; the Employee did. However, as stated in Rev. Rul. 84-79, 1984-1 C.B. 190, the direct ownership requirement of I.R.C. § 1504(a) is interpreted to mean beneficial ownership. *Miami National Bank v. Commissioner*, 67 T.C. 793 (1977). This interpretation recognizes that substance rather than form should control in determining 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. The court in *Macon* premised its decision on the Supreme Court's statement that "taxation is not so much concerned with the refinement of title as it is with actual command over the property taxed. ..." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

Parent argues that, because of the restrictions it has imposed upon Employee's ownership of the New PC stock, Parent has beneficial ownership of such stock. First, Parent loaned the funds to Employee in order for Employee to acquire the New PC stock (and for New PC to use such funds to acquire the intangible assets of Old PC). These funds were loaned on a nonrecourse basis with Employee's New PC stock as collateral. Thus, Parent argues that it, and not Employee, is at risk with respect to such stock. Second, Employee is required to vote the New PC stock as Parent recommends. In addition, Parent has adopted procedures by which to ensure that its recommendation will be respected. Third, Employee is not entitled to dividends distributed with respect to his New PC stock. Moreover, any dividends erroneously distributed must be immediately contributed by Employee to New PC.

However, § Y of State X precludes beneficial ownership of a professional corporation by anyone other than a licensed individual. Parent is not a licensed individual. Thus, under § Y, 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.

Moreover, other provisions of § Y enforce this prohibition. For example, § Y only provides an exception to this rule if there is a statute, rule or regulation applicable to the particular profession (in this case, medical) that so provides. Parent has not identified any such exception, and neither have we. Therefore, § Y must be read as providing no exception.

In addition, § Y provides that any transfer of the beneficial ownership of the stock of a professional corporation to someone other than another licensed individual is void. In other words, the transfer is given no legal effect (i.e., it is as if it never occurred). In this case, Employee initially acquired the beneficial ownership of the stock of New PC. Employee transferred funds to New PC and received all of the stock of New PC. Through the restrictions attached to the stock (and the other provisions described above), Employee attempted to transfer beneficial ownership in New PC stock to Acquiring. However, under § Y such transfer is void. Therefore, Employee remains the beneficial owner of the New PC stock.

Finally, § Y provides that a shareholder of a professional corporation (i.e., a licensed individual) may not enter into a voting trust or other arrangement with anyone other than a licensed individual. Moreover, § Y further provides that, if the shareholders attempts to do so, any such trust or other arrangement is void. Thus, Employee (or the former shareholders of Old PC) could not enter into a voting trust or other arrangement with Parent in an attempt to circumvent the clear prohibition of § Y.

Accordingly, Parent cannot be considered the beneficial owner of the New PC stock. Consequently, Parent cannot be considered the owner of the New PC stock for purposes of I.R.C. § 1504(a). Therefore, New PC cannot be considered a member of the Parent consolidated group.

Parent recognizes that § Y of State X, on its face, precludes beneficial ownership of the stock of a professional corporation by anyone other than a licensed individual. However, Parent argues that other provisions of State X law dealing with the "corporate practice of medicine" doctrine have been interpreted less strictly in State X in recent years. Therefore, Parent argues that § Y should be also.

The "corporate practice of medicine" doctrine precludes a physician (in his capacity as a physician) from being employed in State X by a corporation. *Case X*. However, this doctrine has since been interpreted (by subsequent legislation and regulations) to allow for physicians to be employed by professional corporations, as well as by certain types of non-profit corporations. Thus, Parent argues that since these types of entities can employ physicians, they can also be considered as beneficial owners of the stock of professional corporations under § Y. Consequently, Parent argues that it complies with § Y, based on what it understands to be the current (and still evolving) doctrine of the "corporate practice of medicine."

As noted above, the language of § Y is quite clear and provides for an exception only under the conditions specified therein. No such exception has been identified. In addition, we decline to speculate whether § Y might be interpreted differently under Parent's understanding of the "corporate practice of medicine" doctrine in

absence of guidance by a court or regulatory authority in State X. In the absence of such guidance, § Y should be interpreted according to its plain meaning.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

Please call if you have any further questions.

By: _____
STEVEN J. HANKIN
Branch Chief
Corporate Branch

cc: