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Doctor's interests in medical practices and surgery center can be separate for PAL purposes

PLR 201634022 (Technical Advice Memorandum)

A Technical Advice Memorandum (TAM) has concluded that IRS lacked the authority to "re-group," for purposes of the passive activity loss (PAL) rules, a doctor's interests in two medical practices at which he was an employee and his indirect interest in an outpatient surgery center. The doctor's treatment of his interests as separate activities wasn't inappropriate in light of the overall facts of the case, including his lack of control over the operations of the surgery center.

Background on PAL rules. In general, under the PAL rules of **Code Sec. 469** , losses from passive activities may only be used to offset passive activity income. "Passive activity" means any activity (i) which involves the conduct of any trade or business, and (ii) in which the taxpayer does not materially participate.

A taxpayer may "group together," and treat one or more trade or business activities or rental activities as a single activity (e.g., for determining material participation), if the activities are an appropriate "economic unit" for measuring gain or loss for PAL purposes based on all the relevant facts and circumstances. (**Reg. § 1.469-4(c)(1)**) The factors given greatest weight are: similarities and differences in types of business; the extent of common control; the extent of common ownership; geographical location; and interdependencies between or among the activities. (**Reg. § 1.469-4(c)(2)**)

In general, once a taxpayer has grouped activities into appropriate economic units, the taxpayer must continue to use that grouping in subsequent tax years unless a material change in the facts and circumstances make it clearly inappropriate. (**Reg. § 1.469-4(e)**) IRS may regroup a taxpayer's activities if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping is to circumvent the purpose of **Code Sec. 469** .

An example is provided in **Reg. § 1.469-4(f)(2)** illustrating IRS's authority to re-group, which involved doctors who formed a partnership which they controlled but in which they did not martially participate. The doctors transferred medical equipment to the partnership in exchange for limited partnership interests and treated the partnership's services, which were provided almost entirely to patients of the doctor-partners, as an activity separate from their medical practices-effectively converting a portion of their practices' active income into passive income that could be offset by their unrelated passive losses. Under these facts, IRS found that the medical practice of each doctor and the interest in the partnership were an appropriate economic unit that should be treated as a single activity.

Facts. The taxpayer in the TAM is a doctor (Doctor). Doctor was an employee of Medical Practice 1, an S corporation, through Date 1 and owned an unspecified percentage of its stock of in Year 1. Doctor left the employment of Medical Practice 1 on Date 1 and became an employee of Medical Practice 2, also an S corporation in which he owned stock during his employment, beginning Date 1 through Date 2.

Doctor also held a small ownership interest in Year 1 and Year 2 in a Limited Liability Company (LLC), which in turn owns a percentage of Outpatient Surgery Center, which is also classified as a partnership for tax purposes. The remaining percentage of Outpatient Surgery Center is owned by an unrelated entity that has ownership interests in similar facilities throughout the country. A number of physicians from different medical practices in the City area held ownership interests in LLC in Year 1, including Doctor. LLC was purportedly established by the physicians because they saw a benefit to having an alternative surgical facility in City (other than the local hospital), and Doctor represented that his investment in it wasn't made to change or improve his medical practice.

Outpatient Surgery Center provides outpatient surgery facilities for qualified licensed physicians. While physicians were required to meet certain certification standards in order to use its facilities, they were not required to be owners or be in practice with an owner in order to use them.

Doctor has represented that, under applicable local law, physicians are not permitted to refer patients to an entity in which they have a financial interest. Instead, patients must be given a choice in surgery location. However, patients will often choose Outpatient Surgery Center over a hospital due to its lower cost.

The income generated from Doctor's indirect ownership in the Outpatient Surgery Center (through LLC) is not tied to the number of surgeries he performs at the facility or to the revenue generated by those surgeries, but rather is based on his proportionate share of profits. Prior to the opening of Outpatient Surgery Center in Year 3, the surgeries that could not be performed in Doctor's practice office were performed at the local Hospital. The opening of Outpatient Surgery Center did not affect Doctor's income from his medical practice. During Year 1 and Year 2, Doctor performed surgeries at various locations including Outpatient Surgery Center, the local hospital, and at both Medical Practices.

On their jointly filed returns for Year 1 and Year 2, Doctor and his wife treated LLC as a separate activity from Medical Practice 1 and Medical Practice 2. They also incurred a passive loss on a rental condo in

Year 1, as well as carryover suspended losses for prior years from the condo. They had other, unrelated passive income in Year 1 as well as income from LLC that they treated as passive, with the result that they deducted their entire loss from the condo in Year 1. In Year 2, they incurred another passive loss on the condo and reported passive income from LLC that again allowed them to deduct the entire loss in that year.

The issue in the TAM was whether Doctor's grouping of his interests in Medical Practice 1, Medical Practice 2, and LLC as separate activities was clearly inappropriate such that IRS could re-group them as a single economic unit.

IRS can't re-group interests as single activity. The TAM, distinguishing the facts of this case from those in the reg example, found that IRS lacks authority to re-group Doctor's activities.

The TAM noted that one key distinction between the reg example and the facts of the case was that an unrelated entity was the majority owner of Outpatient Surgery Center and controlled the day-to-day management of it.

The TAM also found that there was no clear indication in this case that Doctor acquired his interest in LLC with a principal purpose of circumventing the underlying purpose of **Code Sec. 469** .

Looking to the 5-factor test in **Reg. § 1.469-4(c)** , the TAM found that there was likely more than one reasonable method by which Doctor's activities could be grouped into appropriate economic units. Although the trade or business activities of Medical Practice 1, Medical Practice 2, and Outpatient Surgery Center were all within the medical industry, they provide different types of medical services. Additionally, Doctor had different ownership interests and exercised different levels of control among Medical Practice 1, Medical Practice 2, and Outpatient Surgery Center, and all three were in different locations and did not share employees or recordkeeping.

Accordingly, since Doctor's grouping of his interests as separate activities wasn't clearly inappropriate, IRS lacked authority to re-group them.

References: For IRS regrouping under the PAL rules, see **FTC 2d/FIN ¶ M-4809** ; **United States Tax Reporter ¶ 4694.10** ; **TaxDesk ¶ 412,013** ; **TG ¶ 17437** .

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