INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 469.03-03
CASE-MIS No.: TAM-100660-16

Chief, Appeals Office
Denver, CO

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Year(s) Involved:
Date of Conference: No Conference Held

LEGEND:

H =
P =
Q =
R =
W =
X =

Y =
Z =
Center =
City =
Hospital =
Date1 =
Date2 =
State1 =
State2 =
Year1 =
Year2 =

Year3 =
N1 =
N2 =
N3 =
N4 =
N5 =
N6 =
N7 =
N8 =
N9 =
N10 =
N11 =
N12 =
N13 =
N14 =
N15 =
N16 =
N17 =
N18 =
N19 =
N20 =
N21 =
N22 =
N23 =
N24 =

ISSUE(S):

Whether the facts and circumstances of this case as described below support or require a determination that one or more of the taxpayers' groupings of activities do not constitute an appropriate economic unit within the meaning of § 1.469-4(c) of the Income Tax Regulations ("regulations"), for purposes of § 469 of the Internal Revenue Code ("Code"), such that the taxpayers' activities must be regrouped under either the general regrouping rule of § 1.469-4(e)(2) or the Commissioner's regrouping authority of §1.469-4(f) to prevent tax avoidance.

CONCLUSION(S):

We conclude that the facts and circumstances of this case, as presented and analyzed under the five-factor test of § 1.469-4(c), suggest that there may be more than one reasonable method for grouping the taxpayers' activities into appropriate economic units. We also conclude that the facts and circumstances, as presented, do not support a determination that the taxpayers' grouping of the interests in X, Y, and P as separate

activities is clearly inappropriate for purposes of either § 1.469-4(e)(2) or § 1.469-4(f). We further conclude that the facts as presented do not support a determination that H acquired his interest in P and treated it as a separate activity apart from X and Y with a principal purpose of circumventing the underlying purpose of § 469, for purposes of § 1.469-4(f). Therefore, we conclude that the Commissioner does not have authority to regroup the taxpayers' interests in X, Y, and P as a single activity under § 1.469-4(f) to prevent tax avoidance.

FACTS:

The taxpayer husband, H, is an otolaryngologist (an ear nose & throat doctor). H was an employee of X through Date1. X was an S corporation, and H owned N1% of the stock of X in Year1. H left the employment of X on Date1 and became an employee of Y beginning Date1 through Date2. Y was an S corporation, and H owned N2% of Y during this period of employment.

H also held a small ownership interest in Year1 and Year2 in P, which is classified as a partnership for federal tax purposes. H owned an average of N3% of P in Year1 and N4% in Year2. P, in turn, owns N5% of R which is classified as a partnership for federal tax purposes. The other N6% of R is owned by Q, which is classified as a partnership for federal tax purposes and which has ownership interests in similar facilities throughout the country. A total of N7 physicians from N8 different medical practices in the City area held ownership interests in P in Year1, including H.

R provides outpatient surgery facilities for qualified licensed physicians. While physicians were required to meet certain certification standards in order to use R's facilities, the physicians were not required to be owners of R or be in practice with an owner of R in order to use its facilities. R is used extensively by non-owner physicians or surgeons in the City area.

H 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 R over a hospital due to its lower cost. The charge for surgery at a hospital is generally much higher than at an independent outpatient surgery center such as R.

According to the taxpayers' submission, the income generated from H's indirect ownership in R (through P) is not tied to the number of surgeries he performs at R's facility or to the revenue generated by those surgeries. Moreover, even if H did not perform any surgeries at R, he would still receive the same proportionate share of R's profits allocable to his ownership interest in P. Prior to the opening of R in Year3, the surgeries that could not be performed in H's practice office were performed at the local Hospital. The opening of R did not affect H's income from his medical practice, but his patients were given a choice as to where to have the surgery performed. Moreover, the

taxpayers argue that there are no interdependencies between X, Y, and R. H was compensated for his surgical services to patients through medical charges made by X or Y. The revenue generated by R through facility charges are separate from the charges for medical services rendered by H to his patients.

The number and locations of surgeries performed by H in Year1 are as follows: N9 surgeries performed at R; N10 surgeries performed at Hospital; N11 surgeries performed at X offices; N12 surgeries performed at Y offices; and N13 surgeries performed at Center. The number and locations of surgeries performed by H in Year2 are as follows: N14 surgeries performed at R; N15 surgeries performed at Hospital; N16 surgeries performed at Y offices; and N17 surgeries performed at Center.

The taxpayers' submission further states that P is a limited liability company that was established by a group of physicians to acquire an interest in R. The owners of P tend to be local City area physicians because they saw a benefit to having a surgical facility in the City area which would give City area patients a lower-cost choice for their surgical needs as opposed to Hospital being the only available surgical facility. The taxpayers represent that H's investment in P was not made to improve, increase, or change H's medical practice.

The taxpayers, H and W, filed joint returns for Year1 and Year2 and treated P as a separate activity from X and Y. The taxpayers incurred a passive loss of $N18 on a rental condo located in State2 in Year1, identified on their return as Z. The taxpayers had $N19 in carryover suspended losses for prior years from the Z condo. The taxpayers had $N20 of other passive income and $N21 of income from P that the taxpayers treated as passive income in Year1. Accordingly, the entire $N22 loss from the Z condo was deducted in Year1. In Year2, the taxpayers incurred a $N23 passive loss on the Z condo. The taxpayers reported $N24 of passive income from P, allowing the taxpayers to deduct the entire $N23 loss in Year2.

LAW AND ANALYSIS:

Section 469(a) of the Code disallows the passive activity loss or passive activity credit for the taxable year of any taxpayer subject to § 469.

Section 469(c) provides that, for purposes of § 469, the term "passive activity" means any activity (A) which involves the conduct of any trade or business, and (2) in which the taxpayer does not materially participate.

Section 469(l)(1) provides that the Secretary shall provide such regulations as may be necessary or appropriate to carry out provisions of § 469, including regulations which specify what constitutes an activity, material participation, or active participation for purposes of § 469.

Section 1.469-4(b)(1) provides that trade or business activities are activities, other than rental activities or activities that are treated under § 1.469-1T(e)(3)(vi)(B) as incidental to an activity of holding property for investment, that (i) involve the conduct of a trade or business (within the meaning of § 162); (ii) are conducted in anticipation of the commencement of a trade or business; or (iii) involve research or experimental expenditures that are deductible under § 174 (or would be deductible if the taxpayer adopted the method described in § 174(a)).

Section 1.469-4(c)(1) provides, generally, that one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of § 469.

Section 1.469-4(c)(2) provides that, except as otherwise provided in § 1.469-4, whether activities constitute an appropriate economic unit and, therefore, may be treated as a single activity depends on all the relevant facts and circumstances. A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. The factors listed below, not all of which are necessary for a taxpayer to treat more than one activity as a single activity, are given the greatest weight in determining whether activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of § 469 –

(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;
(v) Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Section 1.469-4(c)(3) provides that the following examples illustrate the application of § 1.469-4(c). Section 1.469-4(c)(3) Example 1 states that Taxpayer C has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. In this case, after taking into account all the relevant facts and circumstances, there may be more than one reasonable method for grouping C's activities. For instance, depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity; a theater activity and a bakery activity; a Baltimore activity and a Philadelphia activity; or four separate activities. Moreover, once C groups these activities into appropriate economic units, § 1.469-4(e) requires C to continue using that grouping in subsequent taxable years unless a material change in the facts and circumstances make it clearly inappropriate.

Section 1.469-4(c)(3) Example 2 states that Taxpayer B, an individual, is a partner in a business that sells non-food items to grocery stores (partnership L). B also is a partner in a partnership that owns and operates a trucking business (partnership Q). The two partnerships are under common control. The predominant portion of Q's business is transporting goods for L, and Q is the only trucking business in which B is involved. Under this section, B appropriately treats L's wholesale activity and Q's trucking activity as a single activity.

Section 1.469-4(e)(1) provides that, except as provided in § 1.469-4(e)(2) and § 1.469-11, once a taxpayer has grouped activities under this section, the taxpayer may not regroup those activities in subsequent taxable years. Taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years.

Section 1.469-4(e)(2) provides that if it is determined that a taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and must comply with disclosure requirements that the Commissioner may prescribe.

Section 1.469-4(f)(1) provides that the Commissioner 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 (or failure to regroup under § 1.469-4(e)) is to circumvent the underlying purpose of § 469.

Section 1.469-4(f)(2) provides that the following example illustrates the application of § 1.469-4(f). Section 1.469-4(f)(2) Example states that Taxpayers D, E, F, G, and H are doctors who operate separate medical practices. D invested in a tax shelter several years ago that generates passive losses and the other doctors intend to invest in real estate that will generate passive losses. The taxpayers form a partnership to engage in the trade or business of acquiring and operating X-ray equipment. In exchange for equipment contributed to the partnership, the taxpayers receive limited partnership interests. The partnership is managed by a general partner selected by the taxpayers; the taxpayers do not materially participate in its operations. Substantially all of the partnership's services are provided to the taxpayers or their patients, roughly in proportion to the doctors' interests in the partnership. Fees for the partnership services are set at a level equal to the amounts that would be charged if the partnership were dealing with the taxpayers at arm's length and are expected to assure the partnership a profit. The taxpayers treat the partnership's services as a separate activity from their medical practices and offset the income generated by the partnership against their passive losses.

Section 1.469-4(f)(2) Example further states that, for each of the taxpayers, the taxpayer's own medical practice and the services provided by the partnership constitute

an appropriate economic unit, but the services provided by the partnership do not separately constitute an appropriate economic unit. Moreover, a principal purpose of treating the medical practices and the partnership's services as separate activities is to circumvent the underlying purposes of § 469. Accordingly, the Commissioner may require the taxpayers to treat their medical practices and their interests in the partnership as a single activity, regardless of whether the separate medical practices are conducted through C corporations subject to § 469, S corporations, partnerships, or sole proprietorships. The Commissioner may assert penalties under § 6662 against the taxpayers in appropriate circumstances.

The facts of this case are different from the example in § 1.469-4(f)(2). In the example, in order to circumvent the underlying purposes of § 469, the doctors converted a portion of their practices into a single passive income generator by contributing equipment to a separate entity (which they controlled but in which they did not materially participate) and leasing back the equipment at arms-length rates. Substantially all of the partnership's services were provided to the doctors or their patients, roughly in proportion to the doctors' interests in the partnership.

In this case, an unrelated entity, Q, is majority owner of R and controls the day-to-day management of the surgical facility. H and the other partners of P do not have any direct or indirect control over the day-to-day operations of R, unlike H's clear control over Y. In addition, the services provided by R to patients of P's partners likely do not comprise substantially all of R's patient services, and it is even less clear that the services provided by R to the patients of P's partners will be roughly in proportion to the partners' interests in P (or their indirect interests in R).

Thus, while the example in § 1.469-4(f)(2) concludes that the partnership's activities do not separately constitute an appropriate economic unit, it is not necessarily inappropriate to treat P's activity as a separate economic unit in this case. Furthermore, we do not believe that the facts clearly demonstrate that H acquired his interest in P with a principal purpose of circumventing the underlying purpose of § 469. Accordingly, we conclude that the Commissioner would not have the authority to regroup the taxpayers' interests in X, Y, and P as a single activity under §1.469-4(f) to prevent tax avoidance, even if we were to otherwise conclude that taxpayers' other groupings of activities do not constitute appropriate economic units under § 1.469-4(c).

We further conclude that an analysis under the five-factor test of § 1.469-4(c) demonstrates that there may be more than one reasonable method for grouping the taxpayers' activities into appropriate economic units in this case. While the trade or business activities of X, Y, and R (held by H through P) are similar in that they are all in the medical industry and involve the provision of medical services to patients, X, Y, and R provide different types of medical services. Certain surgeries cannot be performed at X's or Y's practice office, and diagnostic and post-operative care is not provided through P or R. H does not have the same kind of management control over R that H exercises over his own medical practice conducted through X or Y. H has different ownership

interests among X, Y, and P. It also appears from the facts that X, Y, and R are in different locations and do not share employees or recordkeeping. Accordingly, we conclude that an analysis of the facts and circumstances of this case under § 1.469-4(c) does not result in a determination that the taxpayers' grouping of the interests in X, Y, and P as separate activities is clearly inappropriate for purposes of either § 1.469-4(e)(2) or § 1.469-4(f).

CAVEAT(S):

We express no opinion regarding whether H materially participated in P for any of the years at issue, or whether H has appropriately accounted for the hours that he performed surgeries at or with respect to R.

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.