



February 2015

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IRS Ruling Permits Tax Consolidation of Captive Professional Corporations

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The IRS recently issued PLR 201451009 permitting a practice management company and two “captive” professional corporations to file a consolidated federal income tax return as members of an affiliated group under IRC §1504(a), notwithstanding that the management company did not own any shares in the PCs. Every company that uses a captive PC business model, including healthcare systems, corporate dental chains, healthcare staffing companies, and professional management companies, should consider this PLR and the potential tax planning opportunities.

The Captive PC Business Model

The captive PC business model is used by companies to comply with the “corporate practice of medicine” (CPOM) doctrine in place in many (but not all) states. The CPOM doctrine generally prohibits a business corporation from practicing medicine or employing a physician to provide professional medical services. Some states have also enacted corporate practice laws applicable to other healthcare professions, including dentistry, nursing, and chiropractic medicine. Most CPOM doctrines are statutory, but some originate from state court decisions or attorney general opinions.

In order to comply with the CPOM rules, the business corporation forms a professional corporation to employ or contract with licensed professionals (physicians, dentists, etc.) to provide the professional services in that state. Under most PC laws, only professionals who are licensed in that state may own shares in the PC and serve as directors of the PC. The business corporation provides management and other administrative services for the PC in exchange for a management fee. In order to ensure the continuity of the relationship between the PC and the management company, a “friendly” physician is selected to serve as the PC’s shareholder and certain protective provisions are embodied in agreements among the management company, PC and shareholder. The nature and extent of the protective provisions are driven by the particular state’s CPOM and PC restrictions, which may vary significantly from state to state.

Affiliated Group Status and Tax Benefits

Corporations in an “affiliated group” enjoy many federal tax benefits, including (1) the option to file consolidated federal income tax returns, (2) using losses of one member to offset the group’s income, (3) the ability to transfer assets between group members without triggering a current tax on gain for the company receiving the assets; (4) potentially tax free dividends between group members; and (5) the potential ability to utilize the tax attributes (such as credits) of one group member for other group members.

Pursuant to IRC §1504(a), in order for a corporation to be in an affiliated group, the common parent or another member of the affiliated group must directly own stock in the includible corporation which represents 80% or more of the corporation's total voting power and which has a value equal to at least 80% of the total value of the corporation's stock. This definition appears to require "direct" ownership of stock in order to qualify as a member of an affiliated group. However, prior PLRs issued in different contexts have suggested that beneficial (rather than direct) stock ownership may be sufficient to satisfy the "affiliated group" requirements. Therefore, prior to the issuance of PLR 201451009, whether a management company and its captive will be deemed to be members of an affiliated group and permitted to file a consolidated tax return was not entirely clear.

The Captive PC Model in PLR 201451009

PLR 201451009 involved an existing affiliated group which included a management company and two PCs formed in different states. One shareholder, who was a licensed professional in both states, owned all of the shares of both PCs. The captive PC model included numerous provisions the cumulative result of which gave the management company effective control over the value and voting of the captive PCs. Such provisions included the following:

- The management company performed all administrative and support services, including financial reporting, billing, and information systems support, on behalf of the PCs in exchange for a fee. The management company also provided all management services for the PCs, to the extent such management did not constitute engagement in the profession.
- The shareholder of the PCs and the management company were parties to a Director Agreement pursuant to which the shareholder served as the sole director of the PCs. The management company had the right to terminate the Director Agreement for any reason, without penalty, and at any time upon notice to the shareholder.
- The shareholder and the management company also entered into a Stock Transfer Restriction Agreement (STRA) with each PC. The STRAs prohibited the shareholder from (i) transferring any shares of stock in the respective PCs other than in accordance with the STRA; (ii) causing the PC to make a dividend or other distribution or issue additional equity interests or rights to acquire additional equity interests; and (iii) consenting to a liquidation or dissolution of a PC without the prior consent of the management company.
- The STRAs further required the shareholder to transfer all of the shares of the relevant PC to a new person or entity identified by the management company upon the occurrence of certain "Transfer Events." The list of Transfer Events was extensive and included (i) the improper transfer of PC shares; (ii) the shareholder ceasing to be a director of the PC; (iii) the termination of the management agreement for any reason; (iv) the dissolution of the PC; (v) the shareholder voting as a shareholder or director of the PC to issue more of the PC's stock to any person, amend the PC's articles of incorporation or bylaws, declare a dividend, or engage in certain transactions; and (vi) the shareholder breaching a covenant in the STRA or any other agreement with the management company.
- In the event the management company desired to terminate the existence of a PC, it would (i) cause a Transfer Event by terminating the Director Agreement; (ii) direct that the PC's stock be transferred to the management company; and (iii) liquidate the PC or merge the PC into the management company.

The IRS ruled—without much, if any, discussion of its reasoning—that both PCs were members of the management company’s affiliated group and were permitted to join with the group in the filing of a consolidated federal income tax return.

Take Aways

The benefits associated with having captive PCs as members of a business corporation’s affiliated group are potentially significant. In light of PLR 201451009, business corporations desiring affiliated group status for their captive PCs should closely examine their captive PC model to make sure that it includes the requisite control in order to achieve this result. Because CPOM and PC laws are not uniform among the states, it may not be possible to include all of the control terms present in PLR 201451009 in every state. That said, in our experience, it should be possible to implement a captive PC model in most CPOM states under which the management company has enough control over the PCs to satisfy the “affiliated group” standard. It is also important to note that PLRs are binding only on the taxpayer to whom the PLR is addressed, although it does give a window into the current thinking of the IRS.

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